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January 22, 1999

The Honorable Bill Archer
Chairman
House Ways & Means Committee
1236 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

I am pleased to enclose a report of the New York State Bar Association Tax Section commenting on H.R. 18 which would prescribe rules dealing with the assumption of liabilities under section 357 of the Internal Revenue Code. The Tax Section supports the proposed legislation. We believe that it better coordinates the treatment of the assumption of liabilities under section 357 with their treatment under other provisions of the Code, and will prevent certain tax-motivated basis-shifting transactions. We suggest a few modifications to the proposed legislation to provide for correlative adjustments to reflect the actual payment or discharge of a liability governed

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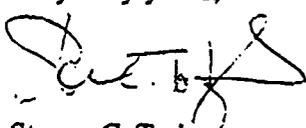
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by the new rules and recommend certain technical changes to the provisions dealing with the assumption of nonrecourse liabilities.

Please let me know if we can be of any further help on the issues raised by the legislation.

Very truly yours,

Steven C. Todrys
Chair

cc: The Honorable William V. Roth, Jr.
The Honorable Daniel P. Moynihan
The Honorable Charles B. Rangel
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**NEW YORK STATE BAR ASSOCIATION TAX SECTION
COMMITTEE ON CORPORATIONS**

REPORT ON PROPOSED LEGISLATION TO AMEND SECTION 357

This Report¹ comments on provisions contained in H.R. 18, 106th Cong., 1st Sess. (1999)² that would prescribe rules governing when liabilities are treated as assumed in section 351³ transactions and corporate reorganizations and limit the step-up in basis that can be obtained by the transferee as a result of the assumption of liabilities in such transactions and reorganizations.

Authorities have held that the transfer of an asset that secures a liability causes the entire liability to be treated as "assumed or taken subject to" for purposes of section 357(c) even if the liability is retained by the transferor as an economic matter and even if the liability is not includable in amount realized under section 1001.⁴ Some taxpayers have engaged in tax-motivated transactions designed to take advantage of these authorities and the inconsistency created when a liability treated as assumed for purposes of section 357(c) is

¹ The report was prepared by the Tax Section's Committee on Corporations. The principal author of the report is David H. Schnabel. Significant contributions were made by Andrew N. Berg and Dana Trier. Helpful comments were received from Samuel J. Dimon, Robert A. Jacobs, Michael L. Schler and Willard B. Taylor.

² The bill is reprinted in the Daily Tax Report, Jan. 7, 1999, pp. L-3 - L-5. Identical legislation has been introduced in the Senate as S. 262.

³ All "section" or "section" references, unless otherwise specified, are to the Internal Revenue Code of 1986, as amended (the "Code").

⁴ See, e.g., *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989) (court rejects the taxpayer's contentions that section 357(c) applies only where the transferor realizes an economic benefit and where the transaction results in the realization of gain under section 1001).

treated as retained by the transferor for other purposes. The potential departure of the tax consequences from the underlying economics in this area has also been a trap for the unwary.

In general, the proposed legislation would better coordinate the treatment of a liability under section 357 with its economic treatment by the parties and its treatment under section 1001. The proposed legislation would delete the references in section 357 to "acquisitions of property subject to a liability" so that it refers only to "assumptions of a liability" and would add a new section 357(d) that would govern when a liability (including a nonrecourse liability) is treated as "assumed." Recourse liabilities generally would be treated as assumed only to the extent that the transferee agreed with the transferor to satisfy the liability. Nonrecourse liabilities generally would be treated as assumed in their entirety by any transferee of collateral that secures the liability, except a nonrecourse liability would be treated as retained in an amount equal to the lesser of (i) the portion of the liability that an owner of other collateral agrees to satisfy and (ii) the fair market value of such other collateral. The proposed legislation also would provide that the transferee's basis in the transferred property could not be stepped up above the fair market value of property as a result of gain recognized to the transferor because of the assumption of liabilities under section 357. In addition, the proposed legislation would provide that if gain is recognized to the transferor as a result of the assumption of a nonrecourse liability and no person is subject to tax under the Code on that gain, the transferee's basis in the property acquired in the transaction is determined by reference to the amount of gain that would have been recognized by the transferor if the transferee had been treated as assuming only a pro rata portion of the nonrecourse liability.

I. Summary of Conclusions

1. We support the proposed legislation. We believe that for most transactions the legislation would substantially improve the alignment of the treatment of a liability under section 357 with the treatment of the liability by the parties as an economic matter and the treatment of the liability under section 1001. This alignment would allow the tax consequences in section 351 transactions to more closely reflect their underlying economics and would curtail the tax-motivated transactions designed to take advantage of the disconnect between tax and economics that currently exists under section 357.

2. Although we generally support the proposed rules governing when a liability is treated as assumed and the proposed basis limitation provisions, we believe the legislation should allow for appropriate adjustments (*e.g.*, to the transferee's basis in the transferred property) in certain cases.

3. We recommend that the proposed rules governing the assumption of nonrecourse liabilities be modified to provide that the portion of a nonrecourse liability treated as assumed cannot exceed the value of the transferred collateral unless either (i) all of the collateral securing the liability is transferred or (ii) the amount of the liability exceeds the value of all the collateral securing the liability. In cases where the amount of a nonrecourse liability exceeds the value of all of the collateral securing the liability, the transferee should be treated as assuming a pro rata portion of the liability.

4. We also recommend that the proposed rule limiting the basis step-up that can result from the assumption of a nonrecourse liability where the transferor is not

subject to U.S. tax on the resulting gain be restricted to cases where the transferor and the transferee are closely related.

II. Current Law

Section 357(a) provides that if the transferee in a section 351 transaction or corporate reorganization assumes a liability of the transferor, or acquires property from the transferor that is subject to a liability, the assumption of (or acquisition subject to) the liability is not treated as boot. Section 357(c)⁵ provides that in a section 351 transaction or D reorganization, if the sum of the liabilities assumed plus the liabilities to which the transferred property is subject exceeds the total of the adjusted basis of the property transferred pursuant to the transaction, the excess is gain from a sale or exchange.⁶

The Code does not define when a liability is considered assumed or taken subject to for these purposes. Treasury Regulations under section 357(c) contain an example in which an individual transfers to a corporation in a section 351 transaction properties having a total basis in his hands of \$20,000, one of which has a basis of \$10,000 and is subject to a mortgage of \$30,000. The example concludes that the individual will recognize \$10,000 of gain, the excess of the amount of the liability over the total adjusted basis of all the properties in his hands, and that the same result will follow whether or not the liability is

⁵ Section 357(c) does not apply to transfers effected within a consolidated group. Treas. Reg. section 1.1502-80(d).

⁶ The section 357(c) analysis is computed with reference to the principal amount of the liability. We note that in certain circumstances it make more sense to base the computation on the issue price of the liability. See NYSBA Tax Section, "Report on 'Excess Principal Amount' of Securities under Section 356."

assumed by the transferee. Other authorities have held that where a taxpayer transfers property that secures a recourse liability of the taxpayer, the liability is included in the section 357(c) computation, even if the transferee does not intend to actually satisfy the liability.⁷

III. Tax-Motivated Transactions the Proposed Legislation is Designed to Prevent

The legislative history of the proposed legislation focuses on two types of tax-motivated transactions. Both types involve transferors that are not concerned with current gain recognition because of the availability of losses or credits or their status as non-taxable entities (e.g., foreign or tax-exempt). Assume that FP (a non-U.S. person not subject to U.S. tax) is personally liable for a \$100 debt secured by properties A and B (each of which has a \$50 value and a \$50 basis). FP transfers property A to X (a controlled domestic corporation) and, under the literal language of section 357(c), reports \$50 of gain under section 357(c) because property A was subject to the entire \$100 liability. X records a \$100 basis in the asset (FP's original \$50 basis plus \$50 of recognized gain). This basis augmentation permits X to generate a \$50 loss on a subsequent sale of property A or enables X to deduct \$50 of additional depreciation. No further tax consequences are prescribed under current law.

The second type of transaction involves the use of the same liability to obtain multiple basis step-ups. Assume FP (from the example above) transfers property A to Y (a domestic subsidiary) and property B to Z (a second domestic subsidiary). FP may similarly

⁷ See, e.g., *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989) (section 357(c) gain even though taxpayer remained personally liable for the debt and debt was not includable in the taxpayer's amount realized under section 1001); *Rosen v. Commissioner*, 62 T.C. 11 (1974) (section 357(c) gain even though taxpayer remained personally liable for debt).

argue that each transfer gives rise to \$50 of gain under section 357(c) and that therefore each of Y and Z takes a \$100 basis in the property it receives.

IV. Explanation of Proposed Legislation

A. Rules for When a Liability is Treated as Assumed

The proposed legislation would (i) delete the references in the provisions governing section 351 transactions and corporate reorganizations to “acquisitions of property subject to a liability” so that they would refer only to “assumptions of a liability” and (ii) add a new section 357(d) that would govern when a liability (including a nonrecourse liability) is treated as “assumed.” Different rules would apply, depending upon whether the liability is recourse or nonrecourse. Specifically, the proposed legislation provides:

(d) DETERMINATION OF AMOUNT OF LIABILITY ASSUMED.--

(1) IN GENERAL.--For purposes of [section 357], section 358(d), section 362(d), section 368(a)(1)(C), and section 368(a)(2)(B), except as provided in regulations--

(A) a recourse liability (or a portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability; and

(B) except to the extent provided in paragraph (2), a nonrecourse liability shall be treated as having been assumed by the transferee of any asset subject to such liability.

(2) EXCEPTION FOR NONRECOURSE LIABILITY.--The amount of the nonrecourse liability treated as described in paragraph (1) (B) shall be reduced by the lesser of--

(A) the amount of such liability which an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to satisfy, or

(B) the fair market value of such other assets (determined without regard to section 7701(g)).

(3) REGULATIONS.--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and section 362(d). The Secretary may also prescribe regulations which provide that the manner in which a liability is treated as assumed under this subsection is applied, where appropriate, elsewhere in this title.

B. Limitation of Basis Increase Attributable to Liability Assumption

Section 362 generally provides that the transferee's basis in property acquired in a section 351 transaction or corporate reorganization is the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor in the transfer. The proposed legislation would add a new section 362(d) that would limit the basis increase to the transferee in certain circumstances. Specifically, the proposed legislation provides:

(d) LIMITATION ON BASIS INCREASE ATTRIBUTABLE TO ASSUMPTION OF LIABILITY.--

(1) IN GENERAL. - In no event shall the basis of any property be increased under [section 362(a) or (b)] above the fair market value of such property (determined without regard to section 7701(g)) by reason of any gain recognized to the transferor as a result of the assumption of a liability.

(2) TREATMENT OF GAIN NOT SUBJECT TO TAX. -- Except as provided in regulations, if--

(A) gain is recognized to the transferor as a result of an assumption of a nonrecourse liability by a transferee which is also secured by assets not transferred to such transferee; and

(B) no person is subject to tax under this title on such gain.

then, for purposes of determining basis under [sections 362(a) and (b)], the amount of gain recognized by the transferor as a result of the assumption of the liability shall be determined as if the liability assumed by the transferee equaled such transferee's

ratable portion of such liability determined on the basis of the relative fair market values (determined without regard to section 7701(g)) of all of the assets subject to such liability.

V. Need for Correlative Adjustments

The proposed legislation governs the assumption of liabilities for purposes of sections 357, 358(d), 362(d), 368(a)(1)(C) and 368(a)(2)(B). We believe that consistent treatment of liabilities for all purposes of the Code would generally be desirable. Therefore, if a liability is treated as assumed by the transferee (or retained by the transferor) in a transaction governed by section 357, we believe the liability (in the amount treated as assumed) should generally be treated as a liability of the transferee or transferor, as the case may be, for other purposes of the Code as well. Thus, for example, if a liability that was treated as assumed by the transferee for purposes of section 357 is later paid by the transferor, the payment should be treated under general tax principles as a capital contribution by the transferor at the time of payment. Similarly, if a lender forgives a loan that was treated as retained by the transferor under the proposed legislation even though the transferred property was subject to the liability, the transferor (and not the transferee) should have income from discharge of indebtedness. This treatment would allow consistency between the tax treatment of the liability in the transaction (including the computation of basis and any section 357(c) gain) and the tax treatment of the liability after the transaction.

The premise behind the basis limitation rules generally appears to be that the transferee should not receive a step-up in basis as a result of the assumption of a liability if there is reason to doubt that the transferee will actually satisfy the liability. While we generally support these limitations, we believe that appropriate subsequent adjustments need

to be made to take into account how much of the liability is actually satisfied by the transferee.⁸ Adjustments also may be appropriate in cases where the liabilities treated as assumed under section 357 exceed the value of the property transferred in the transaction. For example, if a taxpayer contributes to a subsidiary property with a \$100 value that secures a \$130 nonrecourse liability, the basis of the property to the subsidiary may not (under proposed section 362(d)(1)) be stepped up above \$100. However, if the property subsequently appreciates in value and is sold for \$150 (with \$130 being used to repay the liability), the subsidiary should only recognize \$20 of gain and, because the subsidiary has satisfied the entire liability, its basis in the transferred property should be adjusted to take into account that entire liability. Even if the property is not sold, if the liability is satisfied in the ordinary course, some reconciliation should be made. For example, the \$30 excess could be treated as contingent purchase price paid, with a basis increase when the liability is paid or otherwise becomes noncontingent. *See, e.g.,* Treas. Reg. section 1.338(b)-3T.

Other adjustments are also required. For example, if the property does not appreciate and is foreclosed upon, the amount realized should be adjusted to take into account the fact that the transferee did not receive basis credit for the portion of the liability that exceeded \$100.⁹ *Commissioner v. Tufts*, 461 U.S. 300 (1983) (the rationale for including

⁸ A similar rule is currently provided in section 108(e)(4)(A) to deal with situations in which indebtedness is acquired by a person related to a debtor and the indebtedness is treated as acquired by the debtor.

⁹ This adjustment presumably would be the result under current Treas. Reg. section 1.1001-2(a)(3), which provides that the discharge of a liability is not includable in amount realized if the liability was incurred by reason of the acquisition of the property and was not
(continued...)

a nonrecourse liability in the taxpayer's amount realized is that the liability was included in the taxpayer's basis in the property); *Crane v. Commissioner*, 331 U.S. 1 (1947).

Alternatively, if the lender forgives \$30 of indebtedness, the transferee should recognize no COD income, as the taxpayer received no benefit for the nonrecourse liability in excess of \$100.

Similar adjustments may also be appropriate in cases where basis is limited under section 362(d)(2). For example, assume that FP (a foreign person not subject to U.S. tax) transfers to a domestic subsidiary \$200 of collateral (with a \$0 basis) securing a \$100 liability and retains \$800 of collateral also securing the liability. Absent an agreement by FP to satisfy a portion of the liability, the domestic subsidiary would be treated as assuming the entire \$100 liability and FP would recognize \$100 of section 357(c) gain (none of which would be subject to U.S. tax). For purposes of computing the domestic subsidiary's basis in the property, the section 357(c) gain would be recomputed as if only a pro rata portion (\$20) of the liability was treated as assumed and the subsidiary would take a \$20 basis in the property. While we consider this a reasonable result, we think that, if the subsidiary subsequently sells the property for \$200 and uses \$100 of the proceeds to pay the liability, then the subsidiary's basis should be increased by \$80 at that time.

To the extent the foregoing adjustments are not provided for in the statute, specific regulatory authority should be provided.

⁹ (...continued)
taken into account in determining the taxpayer's basis in the property.

VI. Comments on When a Liability is Treated As Assumed

A. General Comments

We believe the proposed legislation would, if enacted, substantially improve current law. With the exception of certain transactions involving nonrecourse liabilities, the legislation generally would treat liabilities as assumed (or retained) in a manner consistent with the underlying economic treatment of the liability and with the tax treatment under section 1001. The legislation would reduce significantly the traps for the unwary present in current law and curtail the ability of taxpayers to artificially manipulate the extent to which a liability is treated as assumed for tax purposes. We note that, while we support the proposed legislation and its objectives, we believe case law precedent may well enable the Internal Revenue Service to successfully attack the tax-motivated transactions which the legislation is designed to prevent. We believe that the legislative history should so indicate.

B. Specific Comments on Rules for Recourse Liabilities

Meaning of "Expected to Satisfy" Requirement The legislative history should elaborate on the intended scope of the requirement that, in addition to agreeing to satisfy a liability, a transferee must "be expected" to satisfy the liability in order for the liability to be treated as assumed.¹⁰ We believe this requirement is appropriate to the extent it is part of the overall analysis, based on all the facts and circumstances, of whether the agreement of the

¹⁰ The Joint Committee on Taxation explanation of the proposed language states that (i) in any case where the transferee agrees to satisfy a liability, the transferee will be treated as expected to satisfy the liability in the absence of facts indicating the contrary and (ii) where more than one person agrees to satisfy a liability or portion thereof, only one will be treated as expected to satisfy the liability (or portion thereof). Technical Explanation of the Joint Committee on Taxation, *reprinted in, Daily Tax Report*, Jan. 7, 1999, p. L-3.

transferee to satisfy the liability has economic substance. However, we believe an inquiry into the ability of the transferee to satisfy the liability ordinarily should not be considered, unless the transferee's ability to pay is so limited that it undermines the economic substance of the agreement between the parties (as would occur, for example, were the transferee insolvent).

Arrangements That Affect Liability Assumption Cases may arise in which a transferee contractually agrees to assume a liability of the transferor but the parties put in place other arrangements so that the transferor ultimately will bear the liability. This could occur, for example, if the debt assumption were coupled with an agreement by the transferor to indemnify the transferee for any payments required to be made on account of a liability or if the transferor issued its own promissory note to the transferee in an amount equal to the assumed liability. Where the transferor agrees to indemnify the transferee for a liability that the transferee assumes contractually, the indemnity, in effect, negates the assumption and the liability should be treated as retained by the transferor for purposes of section 357.

Moreover, we believe this retained liability result would be the result reached under the proposed legislation because, based on all of the facts and circumstances, the transferee has not agreed to satisfy the liability and is not expected to satisfy the liability.

The contractual assumption of a liability by a transferee, coupled with the issuance of a promissory note by the transferor, ordinarily should not prevent the liability from being treated as assumed by the transferee for purposes of section 357(d). To take an easy case, if the transferee assumes a \$100 account payable and, as part of the transaction, the transferor issues a \$100 promissory note to the transferor payable in 10 years, the terms

of the underlying liability are sufficiently different from the note that the note cannot be said to negate the liability assumption. We recognize that the terms of a promissory note could be drafted to mirror the terms of a contractually assumed liability and thereby negate the economic effect of a liability assumption. However, to treat such a liability as retained for section 357 purposes would effectively require that the promissory note be disregarded for other income tax purposes and this would raise a number of significant issues. For example, suppose P transfers \$100 of property with a basis of \$60 to a subsidiary, the subsidiary assumes an \$80 liability of P and P issues a \$80 promissory note to the subsidiary with terms that mirror the terms of the contractually assumed liability. If the liability is treated as retained by P under proposed section 357 (and therefore, in our view, for other purposes of the Code), it would presumably be necessary to disregard any payments made under the note (including amounts that would normally be treated as interest) to fund the subsidiary's actual payment of the liability. Rules would also need to be developed to deal with what would happen if the subsidiary disposed of the note to a third party. For these reasons, we recommend the issuance of a promissory note by the transferor ordinarily not cause a contractually assumed liability to be treated as retained by the transferor for purposes of section 357.¹¹

¹¹ The issuance by the transferor of its own promissory note to the transferee corporation also raises the issues addressed in *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998) and *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989). In *Peracchi* and *Lessinger*, the courts concluded that a note issued by the transferor had basis for purposes of determining whether the liabilities assumed by the transferee exceeded the basis of the assets transferred.

C. Rules for Nonrecourse Liabilities

The proposed legislation contemplates that if a transferor contributes property that secures a nonrecourse liability and agrees to satisfy all or a portion of the liability, the amount of the liability treated as retained by the transferor may not exceed the fair market value of the collateral retained by the transferor. Proposed section 357(d)(2)(b). The rationale behind this rule presumably is that treating the transferor as having retained more than this amount would be inconsistent with the economics surrounding the nonrecourse liability. Thus, for example, if a transferor contributes to a subsidiary \$60 of collateral that secures a \$100 nonrecourse liability, agrees to satisfy the entire nonrecourse liability, and retains collateral with a value of \$40, then, notwithstanding the transferor's agreement to satisfy the entire \$100 liability, \$60 of the liability would be treated as assumed by the transferee.

In contrast, the proposed legislation does not limit the portion of a nonrecourse liability that may be treated as assumed where the amount of the liability exceeds the value of the transferred collateral. We believe that the absence of such a limitation in certain cases may cause the tax treatment to the transferor to depart from the economic consequences of the transaction and cause the transferor's recognized gain under section 357(c) to exceed its realized gain under section 1001.¹² This disconnect may lead to new forms of tax-motivated transactions if the liability is treated as assumed for other purposes of the Code. For

¹² We are also concerned that taxpayers may engage in transactions in the normal course of business without considering the tax consequences. For example, a transferor may contribute \$1,000 of collateral securing a \$1 million nonrecourse liability without realizing that section 357(c) would treat the entire \$1 million as having been assumed.

example, taxpayers may attempt to convert dividends that are subject to U.S. tax into section 357(c) gain which is not subject to U.S. tax. Suppose that FP (a foreign person who is not subject to U.S. tax) contributes \$400 of collateral securing a \$1,000 nonrecourse liability to D (an existing domestic corporation) and retains \$600 of other collateral. The proposed legislation would treat the entire \$1,000 liability as assumed by the transferee (absent an agreement by the transferor to retain a portion of the liability) and FP would have \$600 of gain under section 357(c) (none of which would be subject to U.S. tax). If D now uses the transferred collateral and \$600 of U.S. earnings to repay the entire liability, D may take the position that the repayment is exempt from U.S. tax (including withholding) as D is only repaying its own liability. In this circumstance, it appears that the repayment is (in effect) a distribution of earnings that normally would be subject to U.S. tax.

Accordingly, we recommend that the proposed rules governing the assumption of nonrecourse liabilities be modified so that the portion of a nonrecourse liability treated as assumed may not exceed the value of the transferred collateral unless either (i) all of the collateral securing the liability is transferred to the transferee or (ii) the amount of the liability exceeds the value of all the collateral securing the liability.¹³ In cases where the

¹³ As an alternative, we believe that the proposed legislation might be modified to add a *de minimis* rule as a second exception to the default rule governing nonrecourse liabilities in order to deal with the situation described in footnote 12, *supra*. This rule would provide that, notwithstanding section 357(d)(1)(B) and except as otherwise provided in regulations prescribed by the Secretary, a nonrecourse liability will not be treated as assumed by a transferee for purposes of section 357(d) by reason of a transfer of one more assets that secure the nonrecourse liability if the fair market value of the assets that secure the liability that are acquired by the transferee in the transaction or are already owned by the transferee is relative small (say 10% or less than) compared with the fair market value of all of the assets
(continued...)

amount of a nonrecourse liability exceeds the value of all of the collateral securing the liability, the transferee should be treated as assuming a pro rata portion of the liability determined on the basis of the relative fair market values of all of the assets subject to the liability.

D. Relationship with Standard Under Section 1001

The rules under section 357 for when a liability is treated as "assumed" should be coordinated with the rules under section 1001 governing when the "discharge" of a liability in a sale or exchange is included in the transferor's amount realized. The basic principle underlying proposed section 357(d) is that the treatment of a liability for section 357 purposes should correspond with the underlying economics of the transaction and this principle is similarly reflected in the regulations under section 1001, and the substantial body of authority interpreting section 1001. Moreover, having different standards creates the possibility that a transferor's recognized gain under section 357(c) could exceed its realized gain under section 1001. Such a result seems unintended and at odds with the basic section 351 principle that a transferor recognizes gain equal to the lesser of its realized gain and the value of the boot received.

Except in certain cases discussed above involving the treatment of nonrecourse liabilities, the standard expressed in the proposed legislation for when a liability is treated as "assumed" for section 357 purposes appears to be essentially the same as the standard under section 1001 for when a liability is treated as discharged. However, given the uncertain

¹³ (...continued)
that secure the liability.

interaction under current law between these two sections, the legislative history should elaborate on their intended relationship.

VII. Comments on the Proposed Basis Step-Up Limitations

Proposed new section 362(d)(1) would provide that the basis of property received by a transferee cannot be increased above its fair market value by reason of any gain recognized to the transferor as a result of the assumption of a liability. We believe that this provision is appropriate and would bring section 357 in line with the authorities that limit the basis that can result in the context of the purchase of property with nonrecourse financing.¹⁴ See *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir. 1988) (court holds that the buyer's basis in property acquired with nonrecourse financing was limited to the fair market value of the property); see also *Odend'hal v. Commissioner*, 748 F.2d 908 (4th Cir. 1984); *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

Proposed new section 362(d)(2) would provide that if the transferor recognizes gain as a result of the assumption of a nonrecourse liability and no person is subject to tax under the Code on such gain, the transferee's basis in the property acquired in the transaction is determined by reference to the amount of gain that would have been recognized by the transferor if the transferee had been treated as assuming only a pro rata portion of the nonrecourse liability (based on the relative value of the collateral acquired by the transferee

¹⁴ Another approach that might reduce the need for the correlative adjustments described above would be to provide that the basis limitation applies for purposes of determining losses and deductions but not for purposes of determining gain. Cf. section 1015 (in gift context, transferee takes a carryover basis except that, if the adjusted basis of the property exceeds its fair market value at the time of the gift, then for purposes of determining loss basis equals such fair market value).

and the value of all of the collateral). In situations where the transferor and the transferee are closely related, the contribution of an asset to a subsidiary generally does not meaningfully change the transferor's economic position. In such cases, there may be policy reasons to deny a step-up to the U.S. taxpayer, even though a step-up could have been achieved in an actual sale. However, we believe that application of this provision may be inappropriate in cases where the transferor and the transferee are not closely related.

For example, suppose a U.S. person contributes \$800 of assets to D (a new domestic corporation) in exchange for 80% of the stock of D. Suppose further that an unrelated foreign person (FP) contributes \$400 of assets (with a \$0 basis) securing a \$200 nonrecourse liability to D in exchange for 20% of the stock of D, FP retains \$3,600 of other collateral and that FP and D enter into an agreement in which they agree that D will satisfy the entire \$200 liability. Under proposed section 357(d), D would be treated as assuming the entire \$200 liability and FP would have \$200 of gain under section 357(c). Absent proposed section 362(d)(2), D's basis in the transferred assets would be \$200, computed as \$0 (FP's basis in the assets) plus \$200 (the amount of gain recognized to FP in the transfer). Under proposed section 362(d)(2), D's basis would be recomputed as if D were treated as assuming only \$20 of the \$200 liability since only 10% of the collateral was transferred to D. Thus, under proposed section 362(d)(2), even though D is obligated to a third party to satisfy the entire \$200 liability and the collateral transferred to D is sufficient to satisfy the liability, D's basis in the transferred collateral would be limited to \$20.

In such cases, the contribution meaningfully changes the transferor's economic position with respect to the asset and more closely resembles a sale. Since D's basis in the

transferred assets is limited to fair market value and D is expected to satisfy the nonrecourse liability, we question whether the proposed legislation should limit D's basis in this case, and suggest that the basis limitation apply only where the transferor and transferee are closely related.¹⁵

¹⁵ If D ultimately fails to pay the liability, appropriate adjustments to basis could be made.