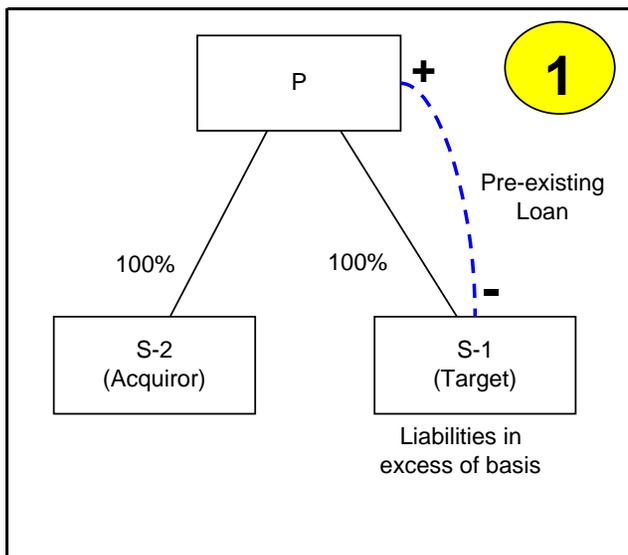
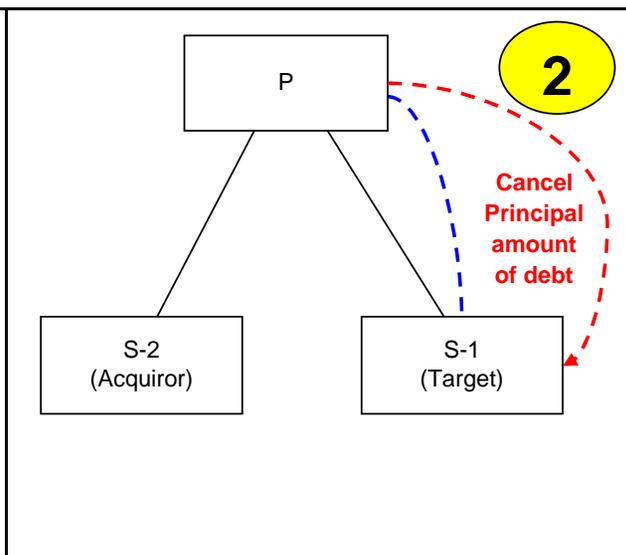


**Avoiding Sec. 357(c)  
in a D Reorganization**

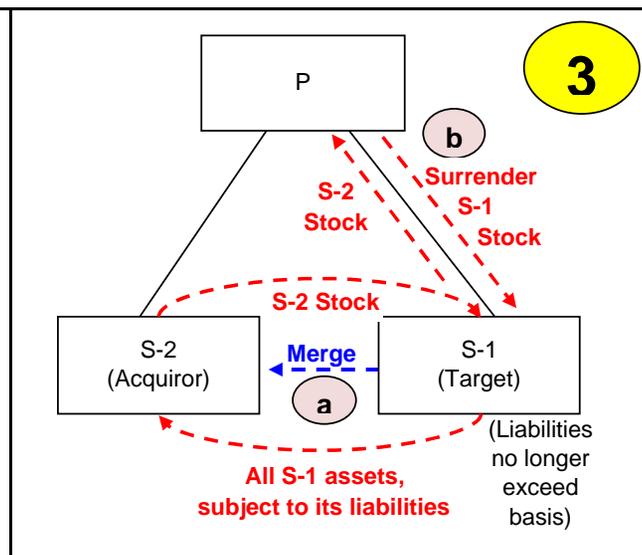
**Initial Structure**



**P Cancelled Debt Owed by S-1**



**S-1 Merges into S-2**



If a transferor's liabilities exceed the tax basis in its assets in a section 361 exchange in a D reorganization, section 357(c)(1)(B) provides that gain must be recognized to the extent the liabilities exceed the basis. In Rev. Rul. 75-161, the IRS concluded that section 357(c)(1)(B) applies when a reorganization qualifies as both A and D reorganizations.

In general, if a shareholder forgives a debt owed to it by its corporation, the transaction is treated as a contribution to the capital of the corporation. Reg. 1.61-12(a). Under section 118(a), a contribution to capital is excluded from the gross income of the corporation.

P's cancellation of the S-1 debt is respected and section 357(c) will not apply. See also, *Simpson v. Commissioner*, 43 T.C. 900 (1965), where the taxpayer was allowed to take preliminary steps to avoid section 357(c) in a section 351 transfer.

Note that section 357(c)(1)(B) was amended in 2004 as part of the American Jobs Creation Act. This amendment obsoletes Rev. Rul. 78-330 to the extent that it holds section 357(c)(1) inapplicable (see Rev. Rul. 2007-8). Section 357(c)(1)(B) now only applies to D reorganizations that are part of a section 355 spin-off / split-off / split-up type transaction.

**Ending Point**

