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.