



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR



FROM: Deborah A. Butler  
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SUBJECT: Effect on Transferor's Basis in Stock of Transferee of  
Contingent Liabilities Assumed By Transferee in an I.R.C.  
§ 351 Exchange

This Field Service Advice responds to your memorandum dated January 8, 1999, requesting reconsideration of a Field Service Advice, dated October 29, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =  
S1 =  
S2 =  
S3 =  
S4 =

ISSUE:

Whether contingent liabilities of the transferor (S1), which had not yet been taken into account by S1 on the date such liabilities were assumed by the transferee (S2) in an I.R.C. § 351 exchange, are considered liabilities for purposes of I.R.C. §§ 357(c)(1) and 358(d).

## CONCLUSION:

Contingent liabilities of S1 that were assumed by S2 in an I.R.C. § 351 exchange, are not considered liabilities for purposes of I.R.C. §§ 357(c)(1) and 358(d) because the payment of such liabilities would give rise to deductions for S2. Rev. Rul. 95-74, 1995-2 C.B. 36.

## FACTS:

The facts were stated in detail in the prior FSA and will not be repeated here. Basically, for the year at issue, corporation P is the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. S1, S2, S3 and S4 are all members of the P group. S1 had tort claims filed against it.

Pursuant to a plan occurring in the year at issue: (a) P contributed cash to S2 in exchange for shares of S2 common and voting preferred stock, and (b) S1 contributed a note from S4 and the stock of S3 in exchange for shares of S2 common stock and the assumption by S2 of S1's tort liability.

Subsequently (but also in the year at issue), S1 sold one-half of its S2 common stock to one unrelated party and the remaining one-half to another unrelated party. After these sales, S2 continued to be a member of the P group (because P's ownership of S2's voting preferred stock satisfied the requirements of I.R.C. § 1504(a)). As a result of these sales, S1 reported a capital loss determined as the difference between the total consideration S1 received for its S2 common stock and its basis in such stock, which was its exchanged basis determined under I.R.C. § 358 by reference to its basis in both the S4 note and the S3 stock.

## LAW AND ANALYSIS

As noted in the prior FSA, the transfer by P of the cash to S2 in exchange for shares of S2 voting common and preferred stock, and the transfer by S1 of the S4 note and the S3 stock to S2 in exchange for voting common S2 stock and the assumption by S2 of the contingent liabilities, qualifies for nonrecognition treatment under I.R.C. § 351(a) by reason of I.R.C. § 357(a).

Section 357(a) provides the general rule that (as applied to this case) S2's assumption of S1's contingent liability will not be treated as money or other property received by S1. One exception to the application of I.R.C. § 357(a) is I.R.C. § 357(c)(1), which provides that if the sum of the liabilities of a transferor that the transferee assumed exceeds the total of the transferor's adjusted basis in the

property transferred to the transferee, the excess amount shall be considered gain to the transferor from the sale or exchange or property.

For purposes of applying I.R.C. § 357(c)(1), I.R.C. § 357(c)(3)(A) provides that a liability the payment of which would give rise to a deduction is excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

Under I.R.C. § 358(d)(1), a transferor reduces its basis in the stock of the transferee it receives in the exchange by the amount of liabilities to which I.R.C. § 357(a) applies. Section 358(d)(2) provides that I.R.C. § 358(d)(1) does not apply to any liability excluded under I.R.C. § 357(c)(3).

The issue in this case is the treatment of the contingent liabilities assumed by S2. More specifically, the issue is whether S1 is required to reduce its basis in the S2 stock it received in the exchange by the amount of such liabilities.

Rev. Rul. 95-74, 1995-2 C.B. 36, noted that the payment of the contingent liabilities that (as applied to this case) were assumed by S2 would give rise to deductions by S2. As a result, Rev. Rul. 95-74 held that such liabilities are not included in determining, for purposes of I.R.C. § 357(c)(1), whether the sum of the liabilities assumed by S2 exceeds the total of the adjusted basis of the property transferred by S1 to S2. Rev. Rul. 95-74 also held that liabilities that are not included in the determination under I.R.C. § 357(c)(1) are also not included in determining, under I.R.C. § 358, S1's basis in the S2 stock received in the exchange.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:





