Internal Revenue Service (I.R.S.)

Revenue Ruling

CONTINGENT LIABILITIES ASSUMED IN SECTION 351 EXCHANGES

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Contingent liabilities assumed in section 351 exchanges. Certain environmental liabilities assumed by a transferee in a section 351 exchange are not liabilities for purposes of sections 357(c)(1) and 358(d) of the Code. In addition, these liabilities assumed in the section 351 exchange are deductible by the transferee as business expenses under section 162 or are capital expenditures under section 263, as appropriate, under the transferee's method of accounting.

ISSUES

(1) Are the liabilities assumed by S in the § 351 exchange described below liabilities for purposes of §§ 357(c)(1) and 358(d)?

(2) Once assumed by S. how will the liabilities in the § 351 exchange described below be treated?

FACTS

Corporation P is an accrual basis, calendar-year corporation engaged in various ongoing businesses, one of which includes the operation of a manufacturing plant (the Manufacturing Business). The plant is located on land purchased by P many years before. The land was not contaminated by any hazardous waste when P purchased it. However, as a result of plant operations, certain environmental liabilities, such as potential soil and groundwater remediation, are now associated with the land.

In Year 1, for bona fide business purposes, P engages in an exchange to which § 351 of the Internal Revenue Code applies by transferring substantially all of the assets associated with the Manufacturing Business, including the manufacturing plant and the land on which the plant is located, to a newly formed corporation, S, in exchange for all of the stock of S and for S's assumption of the liabilities associated with the Manufacturing Business, including the environmental liabilities associated with the land. P has no plan or intention to dispose of (or have S issue) any S stock. S is an accrual basis, calendar-year taxpayer.

P did not undertake any environmental remediation efforts in connection with the land transferred to S before the transfer and did not deduct or capitalize any amount with respect to the contingent environmental liabilities associated with the transferred land.

In Year 3, S undertakes soil and groundwater remediation efforts relating to the land transferred in the § 351 exchange and incurs costs (within the meaning of the economic performance rules of § 461(h)) as a result of those remediation efforts. Of the total amount of costs incurred, a portion would have constituted ordinary and necessary business expenses that are deductible under § 162 and the remaining portion would have constituted capital expenditures under § 263 if there had not been a § 351 exchange and the costs for remediation efforts had been incurred by P. See Rev. Rul. 94-38, 1994-1 C.B. 35 (discussing the treatment of certain environmental remediation costs).

LAW AND ANALYSIS

Issue 1: Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock and immediately after the exchange the transferor is in control of the corporation.

Section 357(a) provides a general rule that a transferee corporation's assumption of a transferor's liability in a § 351 exchange will not be treated as money or other property received by the transferor. Section 357(b) provides an exception to the general rule of § 357(a) when it appears that the principal purpose of the transferor in having the liability assumed was avoidance of Federal income tax on the exchange or, if not such purpose, was not a bona fide business purpose.

Section 357(c)(1) provides a second exception to the general rule of § 357(a). Section 357(c)(1) provides that if the sum of the liabilities the transferee corporation assumes and takes property subject to exceeds the total of the adjusted basis of the property the transferor transfers to the corporation pursuant to the exchange, then the excess shall be considered as gain from the sale or exchange of the property.

For purposes of applying the exception in § 357(c)(1), § 357(c)(3)(A) provides that a liability the payment of which would give rise to a deduction (or would be described in § 736(a)) is excluded. This special rule does not apply, however, to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property. Section 357(c)(3)(B).

Section 358(a)(1) provides that in a § 351 exchange the basis of the property permitted to be received under § 351 without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by (i) the fair market value of any other property (except money) received by the transferor, (ii) the amount of any money received by the transferor, and (iii) the amount of loss to the transferor which was recognized on such exchange, and increased by (i) the amount which was treated as a dividend and (ii) the amount of gain to the transferor which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

Section 358(d)(1) provides that where, as part of the consideration to the transferor, another party to the exchange assumed a liability of the transferor, such assumption (in the amount of the liability) shall, for purposes of § 358, be treated as money received by the transferor on the exchange. Section 358(d)(2) provides that § 358(d)(1) does not apply to any liability excluded under § 357(c)(3).

The legislative history of § 351 indicates that Congress viewed an incorporation as a mere change in the form of the underlying business and enacted § 351 to facilitate such business adjustments generally by allowing taxpayers to incorporate businesses without recognizing gain. S.Rep. No. 398, 68th Cong., 1st Sess. 17-18 (1924); H.R.Rep. No. 350, 67th Cong., 1st Sess. 9- 10 (1921); see also Rev. Rul. 94-45, 1994-2 C.B. 39 (providing for nonrecognition of gain from assumption reinsurance transactions that are undertaken as part of § 351 exchanges). Section 357(c)(1), however, provides that the transferor recognizes gain to the extent that the amount of liabilities transferred exceeds the aggregate basis of the assets transferred.

A number of cases concerning cash basis taxpayers were litigated in the 1970s with respect to the definition of "liabilities" for purposes of § 357(c)(1), with sometimes conflicting analyses and results. Focht v. Commissioner, 68 T.C. 223 (1977); Thatcher v. Commissioner, 61 T.C. 28 (1973), rev'd in part and aff'd in part, 533 F.2d 1114 (9th Cir.1976); Bongiovanni v. Commissioner, T.C. Memo. 1971-262, rev'd, 470 F.2d 921 (2d Cir.1972). In response to this litigation, Congress enacted § 357(c)(3) to address the concern that the inclusion in the § 357(c)(1) determination of certain deductible liabilities resulted in "unforeseen and unintended tax difficulties for certain cash basis taxpayers who incorporate a going business." S.Rep. No. 1263, 95th Cong., 2d Sess. 184-85 (1978), 1978-3 C.B. 482-83.

Congress concluded that including in the § 357(c)(1) determination liabilities that have not yet been taken into account by the transferor results in an overstatement of liabilities of, and potential inappropriate gain recognition to, the transferor because the transferor has not received the corresponding deduction or other corresponding tax benefit. Id. To prevent this result, Congress enacted § 357(c)(3)(A) to exclude certain deductible liabilities from the scope of § 357(c), as long as the liabilities had not resulted in the creation of, or an increase in, the basis of any property (as provided in § 357(c)(3)(B)). P.L. 95-600 (Revenue Act of 1978), sec. 365, 92 Stat. 2763, 2854 (November 6, 1978); see also S.Rep. No. 1263, 95th Cong., 2d Sess. 185 (1978), 1978-3 C.B. 483.

While § 357(c)(3) explicitly addresses liabilities that give rise to deductible items, the same principle applies to liabilities that give rise to capital expenditures as well. Including in the § 357(c)(1) determination those liabilities that have not yet given rise to capital expenditures (and thus have not yet created or increased basis) with respect to the property of the transferor prior to the transfer also would result in an overstatement of liabilities. Thus, such liabilities also appropriately are excluded in determining liabilities for purposes of § 357(c)(1). Cf. Rev. Rul. 95-45, 1995-26 I.R.B. 4 (short sale obligation that creates basis treated as a liability for purposes of §§ 357 and 358); Rev. Rul. 88-77, 1988-2 C.B. 129 (accrued but unpaid expenses and accounts payable are not liabilities of a cash basis partnership for purposes of computing the adjusted basis of a partner's interest for purposes of § 752).

In this case, the contingent environmental liabilities assumed by S had not yet been taken into account by P prior to the transfer (and therefore had neither given rise to deductions for P nor resulted in the creation of, or increase in, basis in any property of P). As a result, the contingent environmental liabilities are not included in determining whether the amount of the liabilities assumed by S exceeds the adjusted basis of the property transferred by P pursuant to § 357(c)(1).

Due to the parallel constructions and interrelated function and mechanics of §§ 357 and 358, liabilities that are not included in the determination under § 357(c)(1) also are not included in the § 358 determination of the transferor's basis in the stock received in the § 351 exchange. See Focht v. Commissioner, 68 T.C. 223 (1977); S.Rep. No. 1263, 95th Cong., 2d Sess. 183-85 (1978), 1978-3 C.B. 481-83. Therefore, the contingent environmental liabilities assumed by S are not treated as money received by P under § 358 for purposes of determining P's basis in the stock of S received in the exchange.

Issue 2: In Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir.1946), the Court of Appeals for the Eighth Circuit held that, after a transfer pursuant to the predecessor to § 351, the payments by a transferee corporation were not deductible even though the transferor partnership would have been entitled to deductions for the payments had the partnership actually made the payments. The court stated generally that the expense of settling claims or liabilities of a predecessor entity did not arise as an operating expense or loss of the business of the transferee but was a part of the cost of acquiring the predecessor's property, and the fact that the claims were contingent and unliquidated at the time of the acquisition was not of controlling consequence.

In Rev. Rul. 80-198, 1980-2 C.B. 113, an individual transferred all of the assets and liabilities of a sole proprietorship, which included accounts payable and accounts receivable, to a new corporation in exchange for all of its stock. The revenue ruling holds, subject to certain limitations, that the transfer qualifies as an exchange within the meaning of § 351(a) and that the transferee corporation will report in its income the accounts receivable as collected and will be allowed deductions under § 162 for the payments it makes to satisfy the accounts payable. In reaching these holdings, the revenue ruling makes reference to the specific congressional intent of § 351(a) to facilitate the incorporation of an ongoing business by making the incorporation tax free. The ruling states that this intent would be equally frustrated if either the transferor were taxed on the transfer of the accounts receivable or the transferee were not allowed a deduction for payment of the accounts payable. See also Rev. Rul. 83-155, 1983-2 C.B. 38 (guaranteed payments to a retired partner made pursuant to a partnership agreement by a corporation to which the partnership had transferred all of its assets and liabilities in a § 351 exchange were deductible by the corporation as ordinary and necessary business expenses under § 162(a)).

The present case is analogous to the situation in Rev. Rul. 80-198. For business reasons, P transferred in a § 351 exchange substantially all of the assets and liabilities associated with the Manufacturing Business to S, in exchange for all of its stock, and P intends to remain in control of S. The costs S incurs to remediate the land would have been deductible in part and capitalized in part had P continued the Manufacturing Business and incurred those costs to remediate the land. The congressional intent to facilitate necessary business readjustments would be frustrated by not according to S the ability to deduct or capitalize the expenses of the ongoing business.

Therefore, on these facts, the Internal Revenue Service will not follow the decision in Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir.1946).

Accordingly, the contingent environmental liabilities assumed from P are deductible as business expenses under § 162 or are capitalized under § 263, as appropriate, by S under S's method of accounting (determined as if S has owned the land for the period and in the same manner as it was owned by P).

HOLDINGS

(1) The liabilities assumed by S in the § 351 exchange described above are not liabilities for purposes of § 357(c)(1) and § 358(d) because the liabilities had not yet been taken into account by P prior to the transfer (and therefore had neither given rise to deductions for P nor resulted in the creation of, or increase in, basis in any property of P).

(2) The liabilities assumed by S in the § 351 exchange described above are deductible by S as business expenses under § 162 or are capital expenditures under § 263, as appropriate, under S's method of accounting (determined as if S has owned the land for the period and in the same manner as it was owned by P).

LIMITATIONS

The holdings described above are subject to § 482 and other applicable sections of the Code and principles of law, including the limitations discussed in Rev. Rul. 80-198, 1980-2 C.B. 113 (limiting the scope of the revenue ruling to transactions that do not have a tax avoidance purpose). See also Notice 95-53, 1995-44 I.R.B. 21 (discussing certain tax consequences of "stripping transactions," including the applicability of § 482).

Rev. Rul. 95-74, 1995-46 I.R.B. 6, 1995 WL 629018 (IRS RRU), 1995-2 C.B. 36

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