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## Published Ruling on Stock-for-Debt Exception

In Revenue Ruling 92-52, 1992-27 I.R.B. 6, the Service described several factual situations arising under the stock-for-debt exception. The ruling provides important guidance on an increasingly critical exception from the sometimes onerous discharge of indebtedness and tax attribute reduction rules of section 108. The ruling answers two questions:

1. To what extent does the stock-for-debt exception or section 108(a)(1)(B) apply when an insolvent debtor outside of a title 11 case issues its stock and cash or other property for an indebtedness held by a single creditor?
2. To what extent does the stock-for-debt exception or section 108(a)(1)(B) of the Code apply when an insolvent debtor outside of a Title 11 case issues its stock for an indebtedness held by one creditor, and issues cash or other property for an indebtedness held by another creditor?

### Stock-for-Debt Exception

Early case law established that a debtor that cancelled outstanding debt by exchanging its own stock for the debt could escape COD income altogether. This important case law exception from COD income was narrowed by the Bankruptcy Tax Act of 1980 and the Deficit Reduction Act of 1984. Section 108(e)(8)(A) now provides that the stock-for-debt exception does not apply to the issuance of nominal or token shares.

Various approaches have been suggested concerning what

constitutes nominal or token stock. But in late 1990, proposed Treasury Regulations were issued on what constitutes nominal or token shares. These proposed regulations focus on three different ratios which are used to determine whether a particular stock issuance to a creditor should be viewed as nominal or token (and thus not qualifying for the stock-for-debt exception).

But until now there has been little guidance concerning other aspects of the stock-for-debt exception.

### Facts

Corporations X and Y each had 10 shares of common stock outstanding, assets with a fair market value of \$40,000, and unsecured debt of \$90,000. The two companies were insolvent to the tune of \$50,000 each, but no Title 11 case had been commenced. Upon completing the transactions, X and Y each had a net worth of \$30,000, and the stock held by the original shareholders has a fair market value of \$10,000.

The payment of indebtedness owed by X and Y would not have resulted in a deduction. The stock issued is not de minimis under section 108(e)(8), and the stock is not disqualified stock under section 108(e)(10)(B)(ii).

### Package Deal

In the first situation, X owes unsecured debt with an adjusted issue price of \$90,000 to a creditor that is unrelated to X. In 1992, X issues its debt with an issue price of \$10,000 and its common stock with a fair market value of \$20,000 to the creditor in exchange for the debt.

Here, X has \$60,000 of discharge of indebtedness income (\$90,000 of debt, less the sum of the \$10,000 issue price of X's new debt and the \$20,000 fair market value of X's stock). But because X is insolvent by \$50,000 immediately before the discharge, X includes \$10,000 as discharge income. X is treated as issuing its new debt of \$10,000 in exchange for \$10,000 of debt and its stock with a \$20,000 fair market value in exchange for the remainder of the debt.

### No Tax Attribute Reduction

The \$50,000 of discharge of debt (attributable to X's insolvency) is allocated to the stock-for-debt exchange, and X is not required to reduce its tax attributes.

The ruling supports this result by noting that the legislative history to the 1980 Bankruptcy Tax Act states that where a package of stock and other property is issued in cancellation of debt, the cash and other property satisfy an amount of debt equal to the cash and the value of the other property. The stock is treated as satisfying the remainder of the debt.

The stock-for-debt exception, and not section 108(a)(1)(B) applies to the entire amount of the discharge of indebtedness attributable to the debtor's insolvency. No tax attribute reduction is required under sections 108(b) and 1017.

### Debt-for-Debt to One/ Stock-for-Debt to Another

In the second situation, Y owed an unsecured debt to A with an adjusted issue price of \$30,000 and an unsecured debt to B with an adjusted issue price of \$60,000. A and B are unrelated to Y. In 1992, Y issues its debt instrument with an issue price

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of \$10,000 to A in exchange for the debt held by A. In a related transaction, Y subsequently issues its common stock with a fair market value of \$20,000 to B in exchange for the indebtedness held by B.

Here, Y has \$20,000 of discharge of indebtedness from the exchange (the \$30,000 debt owed to A less the \$10,000 issue price of Y's new debt instrument). Y has \$40,000 of debt discharge on the stock for debt exchange with B (the \$60,000 debt owed to B less the \$20,000 fair market value of Y's stock.). Thus, the total debt discharge is \$60,000. But because Y was insolvent by \$50,000 just before the discharge, Y includes only \$10,000 in its income.

When determining the potential tax attribute reduction required of an insolvent debtor outside of a Title 11 case, the discharge of indebtedness attributable to insolvency is first allocated to stock-for-debt exchanges. Any remaining discharge of indebtedness attributable to insolvency is allocated to any other exchanges.

### **Partial Reduction Required**

The first \$40,000 of Y's \$50,000 of discharge of indebtedness attributable to its insolvency is allocated to the stock-for-debt exchange with B. Y is not required to reduce its tax attributes under sections 108(b) and 1017 with respect to that exchange. The remaining \$10,000 of Y's discharge of debt attributable to its insolvency is allocated to the debt-for-debt exchange with A.

Because Y is not issuing any stock for the debt held by A, section 108(a)(1)(B)—and not the stock for debt exception—applies to the exchange with A. Y is required to make a corresponding reduction of tax attributes under sections 108(b) and 1017. ■

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