Section 301.—Distributions of Property

26 CFR 1.301–1: Rules applicable with respect to distributions of money and other property.
(Also §§ 61, 108; 1.61–12, 1.108–2(a).)

Corporate distributions of property. This ruling addresses the tax consequences of the distribution by a subsidiary to its parent of parent indebtedness that the subsidiary previously purchased from a party unrelated to the parent.

Rev. Rul. 2004–79

ISSUE

If a subsidiary corporation makes a distribution of parent indebtedness to the parent corporation in a taxable year in which the subsidiary corporation's earnings and profits are greater than or equal to the fair market value of the distributed indebtedness, what are the tax consequences of the distribution?

FACTS

Situation 1

On January 1, Year 1, P, a domestic corporation, issued indebtedness that provides for monthly interest payments of $80,000 payable at the end of each month and a principal payment of $10,000,000 on its stated maturity date of December 31, Year 4. The $80,000 monthly interest payments are qualified stated interest payments within the meaning of § 1.1273–1(c) of the Income Tax Regulations. S, a domestic corporation, has only one class of stock outstanding, all of which is owned by P. On January 1, Year 2, S purchases all of the P indebtedness from A, an individual not related to S under § 1.108–2(d)(2), for cash in the amount of $9,500,000. On that date, the adjusted issue price of the P indebtedness is $10,000,000. On January 1, Year 3, S distributes all of the P indebtedness it holds to P. At the time of this distribution, the fair market value of the P indebtedness is $9,250,000. During Year 3, S makes no other distributions to P. P and S do not join in filing a consolidated return for Years 1 through 3. At all times, the fair market value of P's assets exceeds the amount of its liabilities. At the end of Year 3, S has earnings and profits in the amount of $20,000,000.

Situation 2

The facts are the same as in *Situation 1*, except that at the time S distributes the P indebtedness to P, the fair market value of the P indebtedness is $10,050,000.

LAW

Section 301(a) of the Internal Revenue Code provides that a distribution of property (as defined in § 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in § 301(c).

Section 301(b)(1) provides, in part, that the amount of any distribution shall be the amount of money received, plus the fair market value of the other property received.

Section 301(c) provides that the portion of a distribution which is a dividend (as defined in § 316) is included in gross income, and that the remaining portion of the distribution is applied first against the adjusted basis of the stock and then is treated as gain from the sale or exchange of property.

Section 316(a) provides that a dividend is any distribution of property made by a corporation to its shareholders out of the corporation's earnings and profits accumulated after February 28, 1913, or out of the corporation's earnings and profits of the taxable year, without regard to the amount of the earnings and profits at the time the distribution was made. Generally, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.

Section 317(a) defines "property" for the purposes of the corporate distribution provisions as money, securities, and any other property, except for stock, or rights to acquire stock, in the corporation making the distribution. Section 1.317–1 provides that the term "property" also includes indebtedness to the corporation.

Section 311(a) provides that, except as provided in § 311(b), no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of (1) its stock (or rights to acquire its stock), or (2) property.

Section 311(b) provides that, if a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

Section 312(a) provides that, except as otherwise provided, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of the amount of money, the principal amount of the obligations of such corporation (or, in the case of obligations having original issue discount, the aggregate issue price of such obligations), and the adjusted basis of the other property, so distributed.

Section 312(b) provides that on the distribution by a corporation, with respect to its stock, of any property (other than an obligation of such corporation) the fair market value of which exceeds the adjusted basis thereof, the earnings and profits of the corporation shall be increased by the amount of such excess, and reduced by the fair market value of the property.

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness. Section 1.61–12(a) provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

Section 1.61–12(c)(2)(ii) provides that an issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of § 1.1275–1(b)). The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price. Section 1.61–12(c)(2)(iii) provides that an issuer may be entitled to a repurchase premium deduction upon the repurchase of a debt instrument for an amount greater than its adjusted issue price.

Under § 1.163–7(c), if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price, the excess (repurchase premium) is generally deductible as interest for the taxable year in which the repurchase occurs.

Section 1.1275–1(b)(1) provides that the adjusted issue price of a debt instrument at the beginning of the first accrual period is the issue price. Thereafter, the adjusted issue price of the debt instrument is the issue price of the debt instrument increased by the amount of original issue discount (OID) previously includible in the gross income of any holder (determined without regard to §§ 1272(a)(7) and 1272(c)(1)) and decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest.

Section 1.1272–1(g) provides that the basis of a debt instrument in the hands of the holder is increased by the amount of OID included in the holder's gross income and decreased by the amount of any payment from the issuer to the holder under the debt instrument other than a payment of qualified stated interest.

Section 108(e)(4) provides that for purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in § 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor.

Section 1.108–2(a) provides that the direct or indirect acquisition of outstanding indebtedness by a person related to the debtor from a person who is not related to the debtor results in the realization by the debtor of income from discharge of indebtedness (to the extent required by §§ 61(a)(12) and 108 in an amount determined under § 1.108–2(f)).

Section 1.108–2(f)(1) provides that the amount of discharge of indebtedness income realized under § 1.108–2(a) is measured by reference to the adjusted basis of the related holder (or of the holder that becomes related to the debtor) in the indebtedness on the acquisition date if the holder acquired the indebtedness by purchase on or less than six months before the acquisition date.

Section 1.108–2(g) provides that for income tax purposes, if a debtor realizes income from discharge of indebtedness in a direct or an indirect acquisition under this section (whether or not the income is excludable under § 108(a)), the debtor's indebtedness is treated as new indebtedness issued by the debtor to the related holder on the acquisition date (the deemed issuance). The new indebtedness is deemed issued with an issue price equal to the amount used under § 1.108–2(f) to compute the amount realized by the debtor under § 1.108–2(a) (*i.e.*, either the holder's adjusted basis or the fair market value of the indebtedness, as the case may be). Under § 1273(a)(1), the excess of the stated redemption price at maturity (as defined in § 1273(a)(2)) of the indebtedness over its issue price is OID and, to the extent provided in §§ 163(e) and 1272, is deductible by the debtor and includible in the gross income of the related holder.

ANALYSIS

In *Situation 1*, because P and S have a relationship specified in § 267(b)(3), under § 108(e)(4), S's purchase of the P indebtedness is treated as P's acquisition of that indebtedness. Under § 1.108–2(a), S's acquisition of the P indebtedness results in the realization by P of income from the discharge of indebtedness to the extent required by §§ 61(a)(12) and 108. Because S purchased the P indebtedness for an amount less than its adjusted issue price, P is treated as realizing income from the discharge of indebtedness in an amount determined under § 1.108–2(f). Because the adjusted issue price of the indebtedness ($10,000,000) exceeds S's basis in the indebtedness on the acquisition date ($9,500,000), P realizes $500,000 of income from the discharge of indebtedness.

Under § 1.108–2(g), because P realizes income from the discharge of indebtedness in connection with S's acquisition of the P indebtedness, the P indebtedness is treated as new indebtedness issued by P to S on the acquisition date. The new indebtedness is deemed issued with an issue price equal to S's adjusted basis in the indebtedness, $9,500,000. Under § 1273(a)(1), the $500,000 excess of the stated redemption price at maturity of the indebtedness ($10,000,000) over its deemed issue price ($9,500,000) is OID. In Year 2, P deducts from gross income and S includes in gross income OID of $147,868, calculated pursuant to § 1272. Accordingly, as of January 1 of Year 3, under §§ 1.1275–1(b)(1) and 1.1272–1(g), respectively, the adjusted issue price of the new indebtedness and S's adjusted basis in the indebtedness is $9,647,868.

Under §§ 317 and 1.317–1, the P indebtedness is property for purposes of the corporate distribution provisions. Therefore, S's distribution of the P indebtedness to P is a distribution of property described in § 301. Under § 301(b), the amount of such distribution is the fair market value of the property distributed, $9,250,000. Under § 301(c), because as of the end of Year 3 S has earnings and profits in excess of that amount, the distribution in its entirety is treated as a dividend to P.

Additionally, because the distribution of the P indebtedness to P extinguishes the indebtedness, it is repurchased within the meaning of § 1.61–12(c)(2), and P is treated as having repurchased its indebtedness for an amount equal to the fair market value of the indebtedness, $9,250,000. *Cf. Cora-Texas Manufacturing Co., Inc.*

v. U.S., 222 F. Supp. 527 (E.D. La. 1963), *aff'd per curiam*, 341 F.2d 579 (5th Cir. 1965) (treating a partnership's liquidating distribution to a partner of the partner's preferred stock as if the partner retired the preferred stock for its fair market value); *Rev. Rul. 93–7*, 1993–1 C.B. 125 (ruling that where a partnership distributes indebtedness of a partner to the issuing partner the partner is treated as having satisfied its indebtedness for an amount equal to the fair market value of such indebtedness). Accordingly, under § 1.61–12(c)(2)(ii), P realizes income from the discharge of indebtedness in an amount equal to $397,868, the excess of the adjusted issue price of the P indebtedness ($9,647,868) over the amount of the distribution ($9,250,000).

Under § 311(a), S does not recognize the loss inherent in the P indebtedness on the distribution of the P indebtedness. As a result of the distribution, pursuant to § 312(a), S's earnings and profits are reduced by its adjusted basis in the P indebtedness distributed, $9,647,868.

In *Situation 2*, the tax consequences of S's purchase of the P indebtedness are the same as in *Situation 1*. In Year 3, the amount of the distribution of the P indebtedness determined pursuant to § 301(b) and treated as a dividend under § 301(c) is $10,050,000. Additionally, P is treated as having repurchased its indebtedness for the same amount. Under § 1.163–7(c), P is generally entitled to an interest deduction in an amount equal to the $402,132 excess of the amount of the distribution ($10,050,000) over the adjusted issue price of the P indebtedness ($9,647,868). Under § 311(b), S recognizes gain as if it sold the indebtedness to P for an amount equal to its $10,050,000 fair market value. Thus, S recognizes gain in an amount equal to $402,132, the excess of the fair market value of the indebtedness distributed ($10,050,000) over S's adjusted basis in the indebtedness distributed ($9,647,868). Under § 312(a) and (b), S's earnings and profits must be increased by $402,132, the excess of the fair market value of the indebtedness distributed ($10,050,000) over S's adjusted basis in the indebtedness distributed ($9,647,868), and reduced by the fair market value of the indebtedness distributed, $10,050,000.

HOLDING

If a subsidiary corporation makes a distribution of parent indebtedness to the parent corporation in a taxable year in which the subsidiary corporation's earnings and profits are greater than or equal to the fair market value of the distributed indebtedness, the parent corporation is treated as receiving a distribution treated as a dividend in the amount of the fair market value of the indebtedness on the date of the distribution and may realize discharge of indebtedness income or be entitled to an interest deduction depending on the fair market value of the indebtedness on the date of the distribution relative to its adjusted issue price.

DRAFTING INFORMATION

The principal author of this revenue ruling is Sean McKeever of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. McKeever at (202) 622–7750 (not a toll-free call).