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TAX AND CROSS-COLLATERALIZED NONRECOURSE LIABILITY

by

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ABSTRACT

This Article explores the tax treatment of cross-collateral nonrecourse debt. When using the term cross-collateral debt, we are referring to nonrecourse debt that is connected with more than one piece of property. While tax issues concerning cross-collateralized properties can arise in several circumstances, the focus of this Article is on the tax treatment of a transfer of property subject to a cross-collateralized nonrecourse liability to a controlled corporation in exchange for stock that qualifies for some or all nonrecognition under § 351. The Article also discusses two other tax issues involving cross-collateralized nonrecourse liability—namely, cancellation of debt and determination of basis issues.

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I. Introduction

The transfer of property subject to a nonrecourse liability[1] is treated for tax purposes essentially as if the transferor received cash from the transferee in the amount of the liability.[2] In the context of transfers to corporations that are subject to a nonrecognition provision in the Code, a nonrecourse liability to which the transferred property is subject is treated as boot,[3] which, unless a statute provides otherwise, can cause the recognition of gain or a reduction of basis in the property received by the shareholder in exchange. As to the recognition of gain, it would frustrate the purpose of many nonrecognition provisions to require recognition when transferred property is subject to a debt. To prevent that from occurring in specific transactions, Congress included several provisions in the Code to prevent the recognition of gain.[4] In such cases, the liability is not ignored; instead of causing gain however, it reduces the basis of certain properties.[5] It is still treated as cash received by the transferor, but it does not usually cause the recognition of gain. Instead, the basis of properties received by the transferor in the exchange is reduced.

The Code provision dealing with liabilities in the context of a reorganization[6] or a transfer to a controlled corporation is § 357.[7] The reference to a transfer to a controlled corporation is to an exchange described in § 351. Section 351 provides nonrecognition for a transfer by one or more persons to a corporation in exchange solely for stock of

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1. A nonrecourse liability is a debt for which there is no personal liability and for which the creditor's only recourse for nonpayment is to take or sell the property securing the debt. *See* Comm'r v. Tufts, 461 U.S. 300, 311–12 (1983).

2. Crane v. Comm'r, 331 U.S. 1 (1947).

3. United States v. Hendler, 303 U.S. 564, 566–67 (1938). In a nonrecognition transaction, if property is received that does not qualify for nonrecognition, that other property is referred to as "boot." Boot can be cash (sometimes referred to as "cash boot") or it can be property in kind (sometimes referred to as "non-cash boot").

4. *See, e.g.*, I.R.C. §§ 357, 368(a)(1)(C).

5. I.R.C. §§ 357(d), 358(d).

6. For tax purposes, a reorganization is a transaction that is described in § 368(a).

7. Any citation to a section in this Article is to the Internal Revenue Code of 1986, as amended.

that corporation if immediately afterwards the transferors are in control[8] of the corporation. If, in addition to stock, a transferor receives other property[9] (i.e., boot), any realized gain is recognized but only to the extent of the amount of the boot.[10] For purposes of that provision, nonqualified preferred stock[11] is not treated as stock and so can cause gain recognition. Subject to a few exceptions, the basis of the property transferred to the controlled corporation is the same as the transferor's basis in that property increased by any gain recognized by the transferor.[12]

This Article explores the tax treatment of cross-collateral nonrecourse debt. There has been little written on such treatment by either the Service or academics. When using the term cross-collateral debt, we are referring to nonrecourse debt that is connected with more than one piece of property.[13] While tax issues concerning cross-collateralized properties can arise in several circumstances, the focus of this Article is on the tax treatment of a transfer of property subject to a cross-collateralized nonrecourse liability to a controlled corporation in exchange for stock that qualifies for some or all nonrecognition under § 351. For convenience, we refer to those exchanges as "§ 351 exchanges." The Article also discusses two other tax issues involving cross-collateralized nonrecourse liability—namely, cancellation of debt and determination of basis issues.

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8. Control is defined as the ownership of at least 80% of the voting power of all outstanding stock of the corporation and at least 80% of the total number of shares of nonvoting stock. I.R.C. § 368(c).

9. Bonds are treated as other property (boot) for purposes of § 351. Cash is also treated as boot.

10. I.R.C. § 351(b).

11. Nonqualified preferred stock is defined in § 351(g).

12. I.R.C. § 362(a).

13. The term cross-collateral is sometimes used to describe an agreement that collateral is subject not only to one loan agreement between the lender and borrower, but with any other and all other loan agreements between the lender and the borrower. This is sometimes also referred to as a "dragnet" cross-collateral provision. *See, e.g.*, In Re Natale, 508 B.R. 790 (2014). As noted in the text of the Article, that is not how we are using the term.

II. Section 357 and Nonrecourse Loans

In a § 351 exchange, the transferor's basis in the stock received is equal to the basis of the assets transferred to the corporation increased by income recognized by the transferor and reduced by the amount of boot received.[14] For this purpose, the transferee's "assumption"[15] of a liability is treated as cash received by the transferor and so reduces the basis the transferor has in the corporation's stock.[16]

Section 357(a) provides that, subject to two exceptions,[17] for the purpose of gain recognition a transferee corporation's "assumption"[18] of a liability in a § 351 exchange is not treated as cash. Instead, the liability will reduce the basis of the stock that the transferor received in exchange. The operation of those provisions is shown in the illustrations below.

> Ex. (1): Helen formed the *X* corporation. In exchange for 100 shares of *X* stock, Helen transferred Blackacre to *X*. Helen had a basis of $250,000 in Blackacre, which had a fair market value of $600,000. Blackacre was subject to a mortgage of $130,000, and *X* took Blackacre subject to that mortgage. Helen had no personal liability for the mortgage debt which therefore was a nonrecourse debt. While Helen realizes a gain of $350,000, the $130,000 mortgage liability does not cause Helen to recognize any of that gain. Instead, it reduces her basis in the *X* stock that she receives. Helen's basis in the 100 shares of *X* stock is

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14. I.R.C. § 358(a). For the meaning of "boot," see the text to note 3, *supra*.

15. For purposes of §§ 351 and 357, the term "assumption" has a special meaning set forth in § 357(d). This meaning is discussed later in this Article.

16. I.R.C. § 358(d)(1).

17. One exception is where the principal purpose of the taxpayer was either to avoid federal income tax or was not for a business purpose. I.R.C. § 357(b). The other exception occurs when the amount of the liability assumed exceeds the basis of the properties transferred to the corporation. I.R.C. § 357(c).

18. *See* note 15, *supra*.

$120,000 (her $250,000 basis in Blackacre less the $130,000 mortgage debt).[19]

Ex. (2): The same facts as those stated in Ex. (1) except that Helen's basis in Blackacre was only $100,000. The $130,000 mortgage debt is greater than Helen's basis in Blackacre. If the liability did not cause Helen to recognize a gain, she would have a negative basis of ($30,000) in the *X* stock. Congress frowns upon a negative basis, and to prevent it occurring in a § 351 exchange, Congress added § 357(c) to the Code.[20] That provision requires a transferor to recognize income to the extent that the sum of the liabilities assumed by the corporation exceed the total adjusted basis of the properties transferred by that transferor. So, Helen will recognize income in the amount of $30,000. Helen's basis in the *X* stock will be zero (Helen's $100,000 basis in Blackacre plus $30,000 income recognized minus the $130,000 liability).

In 1999, Congress made several amendments to the Code that changed the treatment of both recourse and nonrecourse liabilities for purposes of a number of provisions, including § 351 exchanges.[21] Section 357 was changed to require that a liability be "assumed" to be taken into account under that section and specified other provisions.[22]

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19. It may be useful to compare this result to an example where there is no liability assumed. Assume Helen contributes Blackacre (not subject to any liability) to *X* in exchange for *X* stock and $130,000 in *X* bonds. Again, Helen realizes a gain of $350,000, but this time she will recognize a gain of $130,000 (the amount of non-cash boot that she receives). Helen's basis in the stock will be $250,000 (her $250,000 basis in Blackacre less the amount of boot that she receives ($130,000) plus the amount of gain that she recognizes ($130,000)). Helen's basis in the bonds will be their fair market value of $130,000.

20. *See* Peracchi v. Comm'r, 143 F.3d 487, 491 (9th Cir. 1998). *But see* J. Clifton Fleming, Jr., *The Highly Avoidable Section 357(c): A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis*, 16 J. Corp. L. 1, 23 (1990) ("Congressional intent behind section 357(c) is unclear.").

21. Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. No. 106-36, § 3001, 113 Stat. 127, 181–84.

22. I.R.C. § 357(a).

The term "assumed" was given a special definition in § 357(d) that is not the same as the usual meaning of that term. In this Article, we will focus only on the treatment given to nonrecourse liabilities.[23]

Section 357(d)(1)(B) provides that, for purposes of that section, a nonrecourse liability secured by a transferred asset will be treated as assumed by the transferee. So, that liability will be treated in accordance with the treatment described above—i.e., in general, it will not cause gain recognition but will reduce the transferor's basis in the stock received in the exchange. Where two or more properties are security for the same debt, and where only one of the properties is transferred in a § 351 exchange, the amount of liability assumed by the corporation is subject to a reduction under § 357(d)(2). If the provision for a reduction does not apply, the entire amount of the debt is treated as assumed by the transferee corporation. So, the default rule is that the entire amount of the liability is deemed to be assumed. The reduction of assumed liability applies only if there is an agreement between the party owning the other property and the transferee corporation. The statute does not spell out the conditions for making a valid agreement. The cross-collateralization problem at which § 357(d)(2) is aimed is illustrated in the following two examples.

> Ex. (3): Randolph owned Blackacre with a fair market value of \$400,000 and a basis of \$180,000. Randolph also owned Whiteacre with a fair market value of \$400,000 and a basis of \$80,000. Randolph borrowed \$200,000 from the Friendly Bank on a nonrecourse loan which was secured by both Blackacre and Whiteacre. Randolph subsequently created the *X* corporation and transferred Blackacre to *X* in a § 351 exchange for stock. Randolph retains ownership of Whiteacre. Blackacre was transferred subject to the outstanding \$200,000 debt to the Friendly Bank. There was no agreement between Randolph and *X* as to how much of that debt Randolph agreed, and is expected, to pay.

23. For the treatment of recourse liabilities and for an examination of other issues involving all liabilities, see Karen C. Burke, *Contributions, Distributions, and Assumption of Liability: Confronting Economic Reality*, 56 Tax Law. 383 (2003).

> Ex. (4): The same facts as those in Ex. (3) except that Randolph created both the *X* and *Y* corporations. Randolph transferred Blackacre to *X* and Whiteacre to *Y* in § 351 exchanges for stock. The properties were transferred subject to the outstanding $200,000 debt to the Friendly Bank. There was no agreement between Randolph and *X* as to how much of that debt Randolph agreed, and is expected, to pay

The questions posed by Ex. (3) are how much of the $200,000 debt should be deemed to have been assumed by the *X* corporation that acquired Blackacre and how much remains with Randolph since he continues to hold Whiteacre. The same issue arises in Ex (4) where the questions are how much of the liability has been assumed by *X* corporation that acquired Blackacre and how much has been assumed by *Y* corporation that acquired Whiteacre. In a 1987 Private Letter Ruling,[24] the Service ruled that the debt is to be divided between the two properties, but the Service did not indicate how the amount allocated to each property is to be determined. A 1990 Private Letter Ruling[25] revoked the 1987 ruling and stated that it was incorrect. The 1990 ruling did not explain how the cross-collateralized debt was to be treated. A strong inference from that revocation is that each property is deemed to be subject to the entire amount of the $200,000 debt.

The amendment to § 357(d) that was made by the 1999 Act makes it certain that unless the exception in that provision applies, the entire amount of the debt will be treated as assumed.[26] Section 357(d)(1)(B) states "except to the extent provided in paragraph (2), a nonrecourse liability shall be treated as having been assumed by the transferee of any asset subject to such liability." The exception provided in § 357(d)(2) states that the amount of nonrecourse liability that will be treated as assumed by the corporation is reduced by the "lesser" of "(A) the amount of such liability which an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to, satisfy; or (B) the fair market value of such other assets. . . ."

24. P.L.R. 87-30-063 (Apr. 29, 1987).

25. P.L.R. 90-32-006 (Apr. 26, 1990); *see also* T.A.M. 1996-40-001 (Nov. 29, 1994).

26. Section 357(d)(1) treats the entire amount of the debt to be assumed by the corporation unless the reduction in § 357(d)(2) applies.

So, in Ex. (3), the amount of the reduction under the exception is zero. While the fair market value of Whiteacre is $400,000, there was no agreement under § 357(d)(2)(A) and therefore the lesser of the two is zero. *X* is treated as having assumed the full liability of $200,000 under § 357(d)(1), and Randolph recognized a gain of $20,000 (the excess of the $200,000 debt over Randolph's $180,000 basis in Blackacre). This is an unfair and inappropriate result since it treats Randolph as having been relieved of the full amount of the cross-collateralized liability despite the fact that Randolph still bears a portion of the liability by continuing to hold Whiteacre.

The unfairness is even more apparent in Ex. (4). Again, the amount of the reduction under the exception in § 357(d)(2) is zero since there is no agreement. *X* is treated as having assumed the full liability of $200,000 under § 357(d)(1), and Randolph recognized a gain of $20,000 (the excess of the $200,000 debt over Randolph's $180,000 basis in Blackacre). On the exchange with *Y*, the same issue applies. The amount of the reduction under the exception is again zero. *Y* is also treated as having assumed the full $200,000 liability under § 357(d)(1). Randolph would be treated as recognizing a gain of $120,000 (the excess of the $200,000 debt over Randolph's $80,000 basis in Whiteacre).

Clearly, those results treat the transferor inappropriately. Randolph recognizes a total of $140,000 gain despite the fact that if both Blackacre and Whiteacre had been contributed to the same corporation, there would not be any gain recognition.[27] Essentially, the full liability is counted twice. Randolph can avoid this result with a valid agreement but, as discussed in more detail below, there is no reason for such a harsh result to be the default rule and a trap for the unwary. Moreover, there is a risk that an agreement may not be correctly executed because of the absence of guidance as to the requirements of a valid agreement.

This demonstrated unfairness is exacerbated by the provision in § 362(d)(1) that the basis of a contributed asset cannot be increased by gain recognized from an assumption of a liability to a figure greater than its fair market value. Consider the following example.

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27. If both properties had been contributed to *X*, the amount of the liability ($200,000) would not exceed the amount of the total contributed basis ($260,000). Instead, there would be no gain recognition, and Randolph would have a $60,000 basis in his *X* stock (his $260,000 total basis reduced by the assumed liability ($200,000)).

Ex. (5): John owns Blackacre with a basis of $100,000 and a fair market value of $300,000. John also owns Whiteacre with a basis of $80,000 and a fair market value of $300,000. Both Whiteacre and Blackacre are subject to the same debt of $400,000 (i.e., there is cross-collateralization). John transfers Whiteacre to *X* corporation in a § 351 exchange. Without an agreement, the reduction of assumed liability provided by § 357(d)(2) does not apply. So, John recognizes a gain of $320,000 under § 357(c) ($400,000 liability minus $80,000 basis). John might take some comfort in knowing that the gain he recognized will increase the basis of Whiteacre in the hands of *X*.[28] But, the basis cannot be increased by the full $320,000 because that would provide a basis of $400,000, which is $100,000 greater that Whiteacre's fair market value.[29] Instead, *X* will have a basis of $300,000 in Whiteacre. Consequently, $100,000 of the gain that John recognized will not be reflected in the corporation's inside basis of Whiteacre and so will never be recovered.

A valid agreement can avoid this issue. As illustrated by all three examples, without an agreement, there can be extremely harsh consequences to a transferor. Subject to a maximum allocation of fair market value of the other property, taxpayers may use an agreement to allocate the liability in any manner. Congress chose this flexible method of allocating the debt rather than to allocate it proportionately among the encumbered properties according to their fair market values.[30] We don't disagree with allowing this flexibility, but the question is whether there is a better default rule than the current one. Indeed, the Service and Treasury have stated that they "are concerned that [the current default rule] does not reflect the underlying economics of the transfer of [the] property" and are considering promulgating a regulation to

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28. I.R.C. § 362(a).

29. I.R.C. § 362(d)(1).

30. *See* Burke, *supra* note 23, at 393. For transfers by someone who is not subject to U.S. taxation, for purposes of determining basis, a cross-collateralized debt is allocated proportionately among the properties according to fair market value. I.R.C. § 362(d)(2). This latter provision applies only to the determination of basis and is designed to prevent an abuse described in Burke, *supra* note 23, at 396–97.

change that rule.[31] As of this date, no such regulation has been proposed. As we note later, the explicit language of the statute makes it unlikely that the default rule could be changed by any means other than a statutory amendment.

Perhaps, Congress created the current default rule out of a concern that a proportional allocation might be abused by taxpayers. If so, it was a misguided concern. There is no scenario in which a proportional allocation would be an abuse to the tax system. Consider Ex. (3) again:

> Ex. (3): Randolph owned Blackacre with a fair market value of $400,000 and a basis of $180,000. Randolph also owned Whiteacre with a fair market value of $400,000 and a basis of $80,000. Randolph borrowed $200,000 from the Friendly Bank on a nonrecourse loan which was secured by both Blackacre and Whiteacre. Randolph subsequently created the *X* corporations and transferred Blackacre to *X* in a § 351 exchange for stock. Randolph retains ownership of Whiteacre. Blackacre was transferred subject to the outstanding $200,000 debt to the Friendly Bank. There was no agreement between Randolph and *X* as to how much of that debt Randolph agreed and is expected to pay.

As noted above, under the current rules, Randolph recognized a gain of $20,000 ($200,000 liability minus $180,000 basis in Blackacre). However, for this example, assume that a pro rata allocation is the default rule instead. Since both properties are worth $400,000, the debt is split evenly between them ($100,000 to Blackacre and $100,000 to Whiteacre). Under this allocation, the transfer of Blackacre to *X* will not cause gain recognition because Randolph has more than enough basis to cover the $100,000 pro rata liability. Instead, Randolph will reduce his stock basis by the liability and thereby have an $80,000 basis in the *X* stock ($180,000 minus $100,000).

Should this be considered an abuse of the tax system? Since the Code explicitly allows this result with a valid agreement between Randolph and *X* corporation, Congress could not have considered it an abuse, and it is no more so when the allocation arises from a default rule instead of from an agreement. Moreover, Congress expressly provided for a proportional allocation of a cross-collateralized debt for

31. Announcement 2003–37, 2003–1 C.B. 1025, 1026.

purposes of determining the transferee corporation's basis when the transferor is not subject to federal income tax (for example, a non-U.S. person).[32] That provision was designed to prevent a tax abuse, and it is significant that Congress considered a proportional allocation to be less vulnerable to abuse than otherwise.

III. Right to Reimbursement for an Overpayment

One issue that can arise when there is an allocation of a liability among properties owned by different persons is what are the tax consequences if it turns out that one of the parties pays more of the debt than is allocated to him? An overpayment could occur voluntarily but is more likely to occur because of the creditor's exercise of his right to choose how much to collect from each property. The creditor is not bound by the agreement of the parties as to how they will divide the payment of the debt, nor is the creditor bound by an allocation under a default rule if the default rule were amended to provide an allocation. The creditor can choose to collect the debt solely from one of the properties securing it, or the creditor can collect the debt from both properties in whatever proportion he chooses. The tax consequence of an excess payment is not entirely clear and may depend upon whether there is an indemnification requirement either by express agreement or otherwise. The uncertainty of tax consequences is a product of the uncertainty as to whether and the extent to which a debtor who overpays can obtain compensation from the other debtor.

To illustrate, consider again the facts of Ex. (3) with the addition that *X* is treated as assuming a liability of only $100,000 because Randolph and *X* agreed that Randolph will pay the other $100,000 of the outstanding debt. As it turns out, *X* actually pays $150,000 of the debt, and Randolph pays only $50,000. That division of the payment could be caused by the creditor's choosing to collect the debt in that manner or because *X* voluntarily made the excess payment. How is *X*'s payment of $50,000 more of the debt than was assumed by it to be treated? Alternatively, if Randolph paid $150,000 of the debt and *X* paid only $50,000, how would Randolph's payment of $50,000 more than his allocation be treated?

One possibility is that the alteration in the amount of liability borne by the parties has no tax consequence. Regardless of the

32. I.R.C. § 362(d)(2).

allocation, the creditor is entitled to collect the entire $200,000 debt from either Randolph or *X* by foreclosing on the property one of them holds. But, imposing no tax consequence is contrary to tax policy. If *X* pays the $50,000 extra amount, Randolph had not previously been treated as having been relieved of that amount, and so he should not escape tax consequence when later he is actually relieved of it. Similarly, if Randolph pays the extra $50,000, he has added to the capital of *X* who is relieved of that liability. How then should the excess payment be treated? Does it matter whether the reduction of the liability assumed by *X* in the § 351 exchange was attributable to an agreement between *X* and Randolph or whether it was attributable to a default rule that Congress might adopt in a future year, and does it matter whether an agreement contains an express provision for indemnification? As we shall see, the existence of an agreement is necessary for there to be a right to contribution; and, for the person making the overpayment to have a right to any reimbursement, it may be necessary to have an express indemnification provision in the agreement. However, even without a right to contribution, it is possible, but not certain, that the payor will be subordinated to the creditor's right to foreclose on the other encumbered property to collect the amount of the excess payment he made.

If the reduction of the liability assumed by *X* is attributable to an agreement between *X* and Randolph, but the agreement does not contain an express indemnification provision, it is possible that the agreement will be construed to provide each party a contractual right to have the other party bear the amount of the debt agreed to be paid. In effect, that construction would imply an agreement of indemnification.[33] Because it is far from certain that a court would hold that there is an implied right to an indemnification, it would be much safer for the parties to include an express indemnification provision in their agreement.

We will first consider the consequences of an overpayment when the parties executed a valid agreement with either an express or implied provision for indemnification. We will later examine the consequences when there is no right to indemnification.

What are the consequences of an overpayment when there is an allocation agreement that includes or is deemed to include an indemnification right? If the creditor chooses to collect a larger amount from

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33. Of course, the Service might require a valid agreement under § 357(d)(2)(A) to include an indemnification clause.

either party, the payor would then have a right to be reimbursed by the other party who is relieved of that amount of the debt he had assumed or agreed to pay. The obligation of the other party to reimburse the excess amount is a personal liability of that other party. If the party paying the excess amount has a right to reimbursement and fails to exercise it, that constitutes a cancellation of the debt owed by the other party. The tax consequence of the cancellation of the debt depends upon the relationship of the parties. The cancellation could be included in the gross income of other party; it could be dividend income; it could be a contribution to the capital of a corporation; or it could be a gift if the debtors are related individuals.

The right to be indemnified makes the other party personally liable to reimburse the one who overpaid. In addition to collecting directly from the other debtor, *perhaps* the payor also will be subordinated to the right of the creditor to foreclose on the other property as a means of collecting his reimbursement.

If an agreement is made to provide reimbursement, that agreement becomes the source of the liability rather than the underlying debt. The party holding the property that was not foreclosed has dual positions. He is a debtor to the creditor for the amount of any unpaid debt, and he is an obligor to the other debtor for the contractual right to reimbursement for an overpayment. When there is an agreement which includes, or is deemed to include, an indemnification requirement, that creates an in personam liability to reimburse an overpayment. If it is determined that there is no express or implied provision for indemnification of an overpayment in the agreement, it appears that the payor may still have a remedy. The debt is a nonrecourse liability and so there is no personal liability to make payment. The subrogation doctrine nevertheless *might* apply even though the liability is in rem.

So, in Ex. (3), if Randolph were the party that paid the excess amount and if there were a provision for indemnification (or a subordinated right of foreclosure), and if Randolph did not enforce that indemnification or foreclosure right, the resulting debt cancellation would be a contribution to *X*'s capital of its share of the debt. Unless § 108(e)(6) applies, the contribution to *X*'s capital will be excluded from income by § 118. Section 108(e)(6) provides that if a shareholder who holds a debt of a corporation contributes that debt to the capital of the corporation, § 118 will not apply. Instead, the cancellation of indebtedness rules will apply as if the corporation had paid cash for the debt in an amount equal to the shareholder's basis in the debt. Any excess debt over that constructive cash payment will be included in the corporation's gross income unless one of the statutory or common law exceptions apply. While far from certain, it appears that § 108(e)(6) would apply to this situation. If so, what basis does Randolph have in the overpaid portion of the debt that constitutes a cancellation of the other debtor's debt? Since Randolph paid cash to the creditor to acquire his rights (whether or not through a foreclosure sale), his basis is the amount of cash he paid. The corporation would recognize no income since it is deemed to have paid cash for the full amount of the overpaid portion of the debt. In sum, regardless of whether § 108(e)(6) applies, *X* will not recognize any income; and Randolph will increase the basis of his *X* stock by the amount he paid to satisfy *X*'s share of the debt.

There is a problem as to how the amount of the excess payment is to be determined. If the parties made a valid agreement as to how much of the debt each should bear, presumably the determination of an excess amount will follow that agreement. As noted above, there is a possibility that, even without an indemnification right, Randolph may be subordinated to the foreclosure right of the creditor. If so, his position is the same as it would be with an indemnification right except that the amount that can be collected under a foreclosure right may be less than the overpayment in some circumstances. Moreover, with no agreement to rely upon, the determination of each party's proper share of the debt is more difficult.

If *X* is the party that made the excess payment, the failure of *X* to enforce its right of reimbursement or foreclosure would be a cancellation of a debt of Randolph that in this context, unless one of the statutory or common law exceptions apply,[34] will be treated as a § 301 distribution from *X* to its shareholder, Randolph. The § 301 distribution of $50,000 will be dividend income to Randolph to the extent of *X*'s earnings and profits. Currently, dividend income is taxed at capital gain rates.

The situation is quite different if, after Randolph executes an agreement with *X*, Randolph transfers Whiteacre to *Y* in a § 351 exchange in which *Y* takes the property subject to the cross-collateralized debt. *Y* is not a party to the agreement that Randolph made with *X* concerning the allocation of the debt. *X* and *Y* could then

34. For example, if Randolph were insolvent, all or part of the cancelled debt would not be income to him. I.R.C. § 108(a)(1)(B), (3). If any of the cancelled debt is excluded from Randolph's income because of insolvency, some of Randolph's favorable tax attributes may be reduced by § 108(b).

make their own agreement as to the allocation of the debt. If *X* and *Y* do not make a second agreement, the default rule would operate and cause *Y* to be treated as having assumed the entire $200,000 debt. That will not affect *X* since the reduction of its debt assumption occurred at the time of the § 351 exchange between Randolph and *X*. The Service discussed this situation in the Announcement of Proposed Rulemaking it made in 2003.[35] The Service said it was considering two alternative positions to be taken in a subsequent regulation. One position was to treat *Y* as assuming the entire amount of the debt (the Service did not mention the possibility that *Y* and *X* could make a second agreement). The alternative position was to treat the amount of liability that *X* assumed under its agreement with Randolph as a recourse debt, which therefore was not assumed by *Y*. The authors do not believe that the encumbrance on Whiteacre can properly be characterized as anything other than a nonrecourse debt. An agreement to allocate the debt does not affect the rights of the creditor, and so there is no personal liability on the debt "assumed" by the transferee. To the extent that either party is required to indemnify the other for an excess payment, that indemnification liability is a recourse debt, but it is a contingent liability.

One avenue for curing some of this problem would be for Treasury to promulgate a regulation that provides that when a valid agreement of allocation of the debt is made, the parties will be treated as if their debt is the amount they agreed to pay. Treasury has considered promulgating such a regulation but has not yet done so.

While it seems to the authors that an agreement as to the allocation of the debt itself should create an implied right to reimbursement, that could be disputed. It would be preferable to have the parties to the agreement include in the agreement an indemnification provision for any party who pays more than the allocated amount.[36] That could avoid a dispute and litigation over whether such a right exists. In the event of a subsequent transfer of the encumbered property, it will be especially important to make another agreement between the property holders to avoid having the entire amount of the debt assumed by the new transferee. Moreover, that second agreement should include an indemnification provision.

35. Announcement 2003–37, 2003–1 C.B. 1025.

36. The Service could also make an indemnification provision a requirement of a valid agreement.

Is there a remedy for the payor if the courts find that there was no express or implied provision for indemnification and that the debtor is not subordinated to the rights of the creditor? It is likely that there is no remedy for the payor in that circumstance. Contribution has been required when there are joint obligors. For example, one joint tortfeasor is required to reimburse the other joint tortfeasor who is required to pay more than his share of the liability. But that is an in personam liability. When the liability is in rem, there likely is no right to contribution.

Some support for there being an equitable rule requiring contribution might seem to exist in light of the equitable rule applied in the marshaling doctrine. While the marshaling doctrine is not applicable to the instant situation, could the policy underlying that provision suggest that the same approach should be applied? The marshaling doctrine arises when two or more properties are security for the same debt (i.e., cross-collateralization) and one of the properties is also subject to another debt held by a different creditor.[37] The function of the doctrine is to protect a junior lienholder from being squeezed out by a senior lienholder. If the creditor of the cross-collateralized debt chooses to collect the debt from the property that is also a security for another debt and thereby prevents the other creditor from collecting, the marshaling doctrine requires the first creditor to collect instead from the property that is not secured by the other debt unless there are other factors present that would make that inequitable.[38] In the instant situation, it would be inequitable to permit one debtor to escape his share of the debt because the other debtor was forced by the creditor to pay it. But the marshaling doctrine does not impose any additional cost on anyone. It requires the creditor to collect the same amount but to do so in a manner that does not deprive the junior creditor of his security. In the instant situation, to require contribution would impose an additional cost on the contributing debtor. That difference makes it unlikely that a rule would be adopted requiring contribution from the other in rem debtor.

If, as it appears, there is no equitable rule requiring reimbursement, the excess payment would have no tax consequence. As noted above, that would be a poor result from a tax policy consideration. To

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37. *See*, *e.g.*, In Re Oxford Dev., Ltd., 67 F.3d 683 (8th Cir. 1995).

38. That is a general statement of the doctrine. It is applied differently in some states and by federal law. *Id.* at 686–87.

prevent that from occurring, if Congress does amend the default rule, it should consider including a right of indemnification in the amendment. There is a question whether Congress has the power to require indemnification or whether that is within the exclusive province of the states.

It is worth considering the situation of a possible right to reimbursement in the context of the current default rule. An examination of that situation brings to light another aspect of the difficulties caused by the current treatment.

Let us return again to Ex. (3) where no agreement is made and so the default rule provides that the entire amount of the debt is treated as "assumed" by *X*. Keep in mind that the statute's use of the word "assumed" is artificial and should not be conflated with the normal meaning of that term. *X* did not actually assume the liability but rather took the property subject to that encumbrance. If there were no § 357(d), the Service would treat the entire liability as a cash payment to Randolph under its construction of the *Crane* doctrine.[39] The 1999 Act's adoption of § 357(d) modified the application of the *Crane* doctrine and used the artificial term "assumed" as a device to do so.

The creditor is entitled to collect the debt from either property or partly from both. Assume that the creditor chooses to collect the entire debt by foreclosing on Blackacre that is held by *X*. As noted above, it is possible that *X* will have a subordinated right to foreclose on Whiteacre and thereby obtain reimbursement for a portion of its payment, but that is not certain. If *X* has no means of obtaining contribution, that exacerbates the harshness of the current default rule. As previously noted, the Service and Treasury have expressed their concern that the current default rule is unfair and does not accord with financial reality, and they have expressed an intention to remedy that situation.[40]

Consider the situation in Ex. (4) where Randolph transfers Whiteacre to the *Y* corporation and no agreement is made. Current law treats both corporations as having assumed the entire debt. One or both of them will pay less than the full amount since the full amount of the liability was counted twice. If either debtor pays more than its

39. *See supra* notes 24–25 and the text thereto. The *Crane* doctrine is sometimes referred to as the *Tufts* doctrine. *See* Comm'r v. Tufts, 461 U.S. 300, 311–12 (1983).

40. *See* Announcement 2003–37, 2003–1 C.B. 1025.

percentage of the debt and is unable to obtain contribution from the other debtor, an already unfair rule becomes even more abusive.

The pro rata allocation default rule provides a better treatment of those issues, but it still has the problem of perhaps having no right to contribution or foreclosure for an overpayment. In favor of a pro rata allocation is the fact that there will never be a situation where the total amount of the loan assumed by all parties will be greater than the actual loan. This solution would be enhanced if the statute also were to provide a specified right of indemnification, but there is reason to doubt whether Congress has the authority to do that.

IV. What Is a Valid Agreement?

The current statute (§ 357(d)(2)(A)) does not set forth the requirements for making a valid agreement. Must it be in writing? Must there be a formal contract? Is an indemnification clause required? Is there a time frame for making the agreement? Can the agreement be made after an IRS audit has begun? Can an agreement be made after the ownership of the other property has changed? If the transferor simultaneously transfers the other property to another corporation, is the agreement to be made by the transferor or the other corporation? If a valid agreement is not made, the entire amount of the debt will be deemed to have been assumed by the corporate transferee under § 357(d)(1)(B).[41] The IRS needs to provide clear directions as to what are the requirements for qualifying for the reduction. As discussed above, the IRS should consider requiring that an indemnification provision be included in the agreement to avoid some of the issues we discussed involving one party paying more of the loan than was allocated to that party.

Another problem is that if the other property is owned by someone other than the transferor, this provision gives that other party leverage to condition his making the agreement on concessions he demands.

Even if an agreement complies with the requirements, whatever they may be, it will not be effective unless the other party is expected to satisfy the amount he agreed to pay.[42] There are no

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41. Section 357(d)(1)(B) provides that the amount of nonrecourse liability to which the transferred property is subject is treated as assumed by the corporate transferee except to the extent reduced by § 357(d)(2).

42. I.R.C. § 357(d)(2)(A).

indications as to what facts would show that the other party is expected to satisfy that amount of the debt. However, there is a built-in limitation in the Code. Recall that the amount of liability that is assumed by the corporation is reduced by the lesser of (1) the amount agreed to and (2) the fair market value of the other property. Thus, the Code assumes that as long as the value of the property is not less than the allocated amount, the taxpayer likely will be able to cover that amount. In light of that limitation, it might seem that the taxpayer does not need to prove anything else, but that will not always be true. For example, a transferor of encumbered properties to multiple transferees may require each of the transferees to accept a larger portion of the debt than that transferee's appropriate share in order to have protection against one of the transferee's defaulting. In such cases, it would not be expected that the transferees will pay the amount that they agreed upon.

In Announcement 2003–37, the Service raised the question whether there should not be more flexibility for allocation if the value of the encumbered property is less than the allocated amount, but the debtor can prove that he has other assets that are more than sufficient to satisfy the nonrecourse loan.

V. Announcement 2003–37 & Treasury's Authority

As noted above, the Service has not provided any guidance as to what the requirements are for the agreement mentioned in § 357(d)(2)(A). However, in 2003, the Service did consider the operation of this liability assumption provision and promulgated an advanced notice of proposed rulemaking.[43] Although no regulation has been proposed or promulgated as yet, the announcement provides a window into the issues and solutions that the Service was considering.

The announcement recognized some of the issues that we discussed above in our examples and the Service noted that "The IRS and Treasury are concerned that some of these rules do not always produce appropriate results and that it might be desirable to modify certain rules by regulation."[44] The Service also stated that "The IRS and Treasury are considering whether proposed rules should set forth the requirements of an agreement between the transferor and the transferee regarding which party will satisfy a liability, and how such an

43. Announcement 2003–37, 2003–1 C.B. 1025.

44. *Id.* at 1026.

agreement must be evidenced."[45] The announcement does not provide any indication as to what those requirements might be.

The announcement suggests that the Service is considering changing "in certain cases" the default rule of full assumption to a pro rata by fair market value assumption instead.[46] While we agree that this is the appropriate default rule, it is doubtful that the Service has the authority to make such a change through regulation. Such a change would directly conflict with the statutory language of § 357. While the Service has a broad scope of authority to interpret the Code and perhaps an even broader mandate with § 357 since Congress provides in § 357(d)(3) that regulations "may be necessary to carry out the purposes of this subsection," it cannot directly conflict with the Code through a regulation. This may be one of the reasons nothing was ever promulgated after the announcement was published. Even though we agree that the proposed rule would be a better policy, such a change must go through Congress.

VI. Cancellation of Cross-Collateralized Debt

Questions as to the proper tax treatment of a cross-collateralized nonrecourse debt that is secured by properties owned by different persons can arise in circumstances unrelated to a § 351 exchange. If such a debt is cancelled, how is the amount that is cancelled to be allocated among the several debtors?

The cancellation of a debt is income to the debtor unless a statutory exception applies (most of which are in § 108) or a common law exception is applicable. A nonrecourse debt is treated as a debt for this purpose even if the amount of the debt exceeds the fair market value of the property securing it.[47] The measurement of the amount of debt that was cancelled usually presents no difficulties regardless of whether it is a recourse or nonrecourse debt. That is not true if a nonrecourse debt is secured by two or more properties that are owned by different persons. If the debt is cancelled how much of the cancellation is attributed to the several debtors? Consider the following example.

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45. *Id.* at 1029.
46. *Id.* at 1026.
47. I.R.C. § 108(d)(1)(B); Rev. Rul. 92–53, 1992–2 C.B. 48.

> Ex. (6): Paula owns Blackacre with a value of $300,000 and a basis of $120,000. Martha owns Whiteacre with a value of $350,000 and a basis of $80,000. Both Blackacre and Whiteacre are subject to the same $200,000 nonrecourse debt—that is, the debt is cross-collateralized. The creditor forgives the debt, and none of the statutory or common law exceptions to the recognition of income is applicable. There is no agreement between Paula and Martha as to how they will divide the payment of the debt. How much of the debt is treated as cancelled to Paula and how much to Martha?

While both Paula and Martha are liable for the entire $200,000 debt in that the creditor could foreclose on either property for the entire amount, it would be unreasonable to treat each of them as having $200,000 of gross income. If that were the treatment, the cancellation of a $200,000 debt would cause a total of $400,000 of gross income to be recognized. The situation is comparable to the one that arises when one of the properties is transferred to a corporation in a § 351 exchange.

As discussed above, the current rule for a § 351 exchange when there is no allocation agreement is that the entire amount of the debt is treated as an amount realized by the transferor. The Service itself has explicitly recognized that that treatment is unfair, but so far, nothing has been done to change the rule. If the Service is willing to countenance that unfair treatment in the context of a § 351 exchange, would they apply the same approach to a cancellation of indebtedness? One would hope that the Service would not do so, and that the courts would not allow a double taxation of the same item if the Service sought to construe the rule in that manner. A significant difference in the § 351 exchange situation is that for that exchange a statute provides that the entire amount of a cross-collateralized debt be treated as assumed by the transferee unless an agreement is made,[48] and there is no comparable provision concerning a cancelled debt. Also, the *Crane* doctrine, which applies to a § 351 exchange, does not apply to the cancellation of debt situation.

Even if the Service or the courts allocate the debt among the properties securing it, there is a question as to how the debt is to be allocated. For example, should it be according to the fair market values

48. I.R.C. § 357(d)(1)(B).

of the properties at the time the properties became subject to the debt or according to their values at the time the debt is cancelled? If the parties make an agreement as to how much each holder of the properties will pay, should the cancellation be allocated in accordance with that agreement?

Unlike the situation with § 351 exchanges, there is no statutory provision dealing with a cancelled cross-collateralized nonrecourse debt that authorizes an agreement allocating the debt among the debtors. If the owners of the properties execute an agreement as to the amount each will bear, will the cancelled debt be allocated among the parties according to their agreement? It seems likely that the cancellation will be so allocated because it conforms to the likely form in which payment of the debt would have occurred if the debt had not been cancelled. As noted above, if one of the parties pays more of the debt than he agreed to pay, he should have a right of indemnification or contribution from the other party or parties who will then be liable for less than the amount they agreed to pay. Taking into account each owner's right to indemnification, that owner's actual liability is equal to the amount he agreed to pay. Accordingly, only the amount that an owner agreed to pay should be treated as cancelled.

Because it is not certain that there is a right to indemnification or subordination when there is no express contractual provision for indemnification, any agreement among owners of properties with cross-collateralized debt for allocating the payment of the debt should include an indemnification provision.

Consider the facts of Ex. (6) with the change that both Blackacre and Whiteacre were owned by Paula. The cancellation of the $200,000 debt would cause Paula to recognize $200,000 of gross income if none of the exception to cancellation of debt income apply. Paula is the only debtor, so the amount of the debt that was forgiven is the amount she owed. There is no justification for treating a cancellation of a $200,000 debt as causing $200,000 of gross income when only one person is liable for the debt but treating it as causing $400,000 of income when two persons are liable.

VII. Purchased Property Basis with Cross-Collateralized Debt

Under the *Crane* (or *Tufts*) doctrine, if property is taken subject to a debt, the basis of the property includes the amount of the debt. If several properties are purchased subject to the same purchase money debt, how is that debt to be treated in determining the basis of the properties? In other words, how is the debt allocated between properties in determining their basis? Consider the following example.

> Ex. (7): Arthur purchased Blackacre and Whiteacre from Helen. Blackacre had a fair market value of $400,000 and Whiteacre had a fair market value of $800,000. Arthur and Helen executed an agreement of sale under which Arthur agreed to pay Helen $300,000 cash for Blackacre and $500,000 cash for Whiteacre with the balance of payment for both properties to be paid as a promissory note for $400,000 secured by both properties. The agreement did not state how much of the debt was allocated to each property. What basis does Arthur have in each property? The basis will depend upon how the debt is allocated between the properties.

In Ex. (7), it would not be reasonable to allocate the entire $400,000 debt to each property so that Arthur would have a basis of $700,000 in Blackacre and $900,000 in Whiteacre. The purpose of basis is to determine the amount that a taxpayer is deemed to have invested in the property. Obviously, Arthur's total investment including the note is $1,200,000, and providing him with an aggregate basis of $1,600,000 would be unrealistic. So, the debt must be allocated between the two properties in determining their basis.

One possible method of allocation would be to allocate the $400,000 debt between the two properties in proportion to their fair market value. If so divided, Arthur would have a basis of $433,333 in Blackacre, and a basis of $766,667 in Whiteactre. But that would provide Arthur with a basis for each property that was different from its value at the time of its purchase and would not reflect the actual price paid for each property. The debt should be allocated between the properties in such manner as to provide the purchaser with a basis equal to the property's fair market value at the time of purchase. In other words, the entire purchase price of $1,200,000 should be allocated between the two properties in accordance with their fair market values. That requires a determination of the fair market values of the properties, but if a price is agreed upon, that will usually be accepted as reflecting the values. The valuation problem is the same as is encountered when a building is purchased and basis must be determined for the land and the building separately. The purchase price is allocated between the land and the building according to their respective fair market values at the time of purchase. A similar problem occurs when a portion of a parcel of land is sold. The basis of the sold portion is determined by allocating the price paid for the parcel according to the values the portions had at the time that the parcel was purchased.[49]

There is no actual problem with how basis should be determined in this situation. The likely result is clear. Moreover, it is unlikely that a sales contract would fail to state how much is to be paid for each item, and so no allocation issue would arise. Our discussion of this situation serves to illustrate that the cross-collateralization of a debt should not cause the tax law to allocate a debt in a manner that does not conform to the economic substance of the transaction.

VIII. Conclusion

One problem with having a default rule for § 351 exchanges in which the transferee corporation is deemed to have assumed the entire cross-collateralized nonrecourse debt is that a transferor who is unaware of the rule will be subjected to very harsh consequences. That is unlikely to arise frequently when the parties are aware of the issue. In most cases, a valid agreement will be made between the owner of the other property and the transferee corporation at the time of the exchange and that agreement should include an indemnification provision. However, if the agreement is not deemed valid, a transferor may suffer greatly. The question of the validity of an agreement is troublesome in the absence of guidance as to the manner and timing of the agreement and as to what requirements there are to show that the other party is expected to fulfill his agreement. Finally, the transferor is at risk that if the owner of the other encumbered property is someone other than the transferor, that other owner may decline to make an agreement with the corporation or may condition his agreement on concessions.

Apart from the apportionment issues, there are difficulties surrounding the circumstance where one of the debtors pays more than his share of the debt. There are unresolved issues as to whether the other debtor can be required to indemnify the payor for the overpayment and as to what is the amount of the overpayment. It is unfair for a debtor to have no right of contribution for an overpayment, but that may happen in some circumstances. Another aspect of this issue is that a debtor can

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49. *See* Reg. § 1.61–6(a), Ex. (1).

cause adverse tax consequences by failing to enforce a right to contribution.

Congress should remedy one aspect of the current situation by amending § 357 to provide a default rule that apportions the debt pro rata according to the values of the properties securing the debt. It would be desirable to have the statute provide an indemnification provision requiring either party to reimburse the other for a payment in excess of the amount allocated if Congress has the authority to impose that requirement.

Treasury should promulgate regulations (or rulings) specifying the requirements for making a valid agreement. Those rules should include a requirement that the agreement contain an indemnification provision. Treasury should also provide regulations (or rulings) stating what treatment will be accorded to a debtor's payment of more than his share of the debt. Finally, Treasury should promulgate rules as to the tax consequences when one of the properties is transferred after the agreement is made.

In sum, there are many uncertainties in the current status of the transfer of cross-collateralized properties, and there are unfair adverse tax consequences that need to be corrected.

The issues concerning the tax treatment of cross-collateralized nonrecourse debt do not arise exclusively in connection with § 351 exchanges, but that is where they are more likely to occur and where they are more difficult to resolve. We have shown that a similar issue can arise in connection with a cancellation of a cross-collateralized nonrecourse debt, but that issue is more easily resolved. The factors that make the resolution of the § 351 exchange situation difficult (i.e., the express language of § 357(d) and the operation of the principles of the *Crane* doctrine) do not apply to the cancellation of debt situation. However, the questions of indemnification rights and the tax consequences thereof are present.

As to the allocation of a cross-collateralized nonrecourse debt in determining the basis of purchased properties, the resolution seems clear and presents no real problems.