NEW YORK STATE BAR ASSOCIATION
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Report No. 1530
June 7, 2026

The Honorable Scott Bessent
Secretary of the Department of the Treasury, and Acting Commissioner of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Kenneth J. Kies
Assistant Secretary (Tax Policy) of the Department of the Treasury, and Acting Chief Counsel of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: NYSBA Tax Section Report No. 1530 - Report on Selected Issues under Section 108(e)(6)

Dear Secretary Bessent and Assistant Secretary Kies:

Please see attached Report No. 1530 of the Tax Section of the New York State Bar Association (the "**Report**") addressing selected interpretive issues under Section 108(e)(6) of the Internal Revenue Code (the "**Code**"). The Report identifies several areas of uncertainty under current law and provides recommendations for guidance to clarify the application of Section 108(e)(6) in certain commonly encountered transaction patterns.

Section 108(e)(6) governs the treatment of debt contributed to a corporation as a shareholder contribution to capital and determines the extent to which cancellation of indebtedness income is recognized based on the shareholder's adjusted basis in the debt. Despite its longstanding inclusion in the Code, the absence of comprehensive Treasury regulations and the limited scope of other guidance have resulted in significant interpretive uncertainty for the government and taxpayers alike.

The Report focuses on domestic (i.e., non-cross-border) issues involving C corporation transferees outside of the consolidated return or affiliated group context and alternative minimum tax regime. In particular, the Report addresses (i) the determination of whether a debt contribution is made in a shareholder capacity rather than a creditor capacity, including a proposal for guidance to adopt a "dominant motivation" test; and (ii) the interaction of Section 108(e)(6) with Section 108(e)(8) or 108(e)(10) in transactions involving partial contributions of debt, where the remainder of the debt is retained or exchanged for stock or new debt. The Report also assesses related issues such as the role of form versus substance in the context of debt contributions.

We believe that additional guidance under Section 108(e)(6) would promote clarity, consistency, and administrability. The Report sets forth recommendations intended to assist the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") in developing such guidance.

We appreciate the opportunity to comment on these issues and thank Treasury and the IRS for their consideration. If you have any questions or would like to discuss any aspect of the Report, please do not hesitate to contact us. We would be pleased to assist in any way.

Respectfully submitted,

Lawrence M. Garrett
Chair

Enclosure

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Report No. 1530

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SELECTED ISSUES UNDER SECTION 108(e)(6)

June 7, 2026

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Report on Selected Issues Under Section 108(e)(6)

I. INTRODUCTION

This Report ("Report")[1] of the Tax Section of the New York State Bar Association provides suggestions to the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS") for guidance addressing several interpretive issues under Section 108(e)(6).[2] The Report identifies the principal areas of uncertainty, analyzes the relevant statutory text, legislative history, and existing authorities, and offers specific recommendations for the guidance requested. The Report focuses on domestic (i.e., non-cross-border) issues involving C corporation transferees outside of the consolidated return or affiliated group context and alternative minimum tax regime.

Section 108(e)(6) of the Internal Revenue Code of 1986, as amended ("Code"), provides that when a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital, the corporation is treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the debt. The corporation recognizes cancellation of indebtedness income ("CODI") only to the extent the adjusted issue price ("AIP") of the debt exceeds that basis and recognizes no CODI at all where the shareholder holds the debt at full basis.

Despite having been part of the Code since the Bankruptcy Tax Act of 1980,[3] no Treasury regulations have been issued under the provision,[4] and the private letter rulings and other administrative guidance that have been issued by Treasury and the IRS leave many interpretive questions unresolved, creating meaningful uncertainty for taxpayers and their advisors.

This Report focuses primarily on two sets of issues: (i) the determination of whether debt is being contributed by the creditor to the corporate issuer as a shareholder contribution to capital as opposed to an extinguishment of debt in another capacity; and (ii) the interaction of Section 108(e)(6), on the one hand, and Section 108(e)(8) or 108(e)(10), on the other hand (e.g., where a portion of a debt, but not the entire debt, is contributed to capital). Part II of this Report provides

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[1] The principal author of this report is Edward S. Wei, with substantial assistance from Lawrence Garrett, Stuart J. Goldring, and Brian Krause. Helpful comments were received from: William Alexander, Kimberly Blanchard, Andrew Braiterman, Andrew Herman, Kevin Jacobs, Robert Kantowitz, Kathryn Kelly, Elliot Pisem, Arvind Ravichandran, Yaron Reich, Michael Schler, Eric Sloan, Wade Sutton, Linda Swartz, Sara Zablotney, and Libin Zhang. This Report reflects solely the views of the Tax Section and not those of its individual members or any other party.

[2] Unless indicated otherwise, all "Section" references are to the Internal Revenue Code of 1986, as amended, "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, and all "Prop. Treas. Reg. §" references are to proposed Treasury regulations promulgated under the Code; provided that references to provisions discussed in their historical context refer to those provisions as they existed at the relevant time, even where the text of those provisions has been amended since enactment. Section numbers are the same across the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986 unless otherwise noted.

[3] Pub. L. No. 96-589, 94 Stat. 3389 (1980) (hereinafter, the "1980 Act").

[4] Pub. L. No. 103-66, Section 13226(a)(2)(B), 107 Stat. 488 (1993) (amending Section 108(e)(6) to add the introductory clause "Except as provided in regulations"); H.R. Conf. Rep. No. 103-213, at 620 (1993) ("The conference agreement provides authority to the Treasury Department to promulgate such regulations as are necessary to coordinate the present-law rules regarding the acquisition by a corporation of its debt from a shareholder as a contribution to capital ... with the repeal of the stock-for-debt exception.").

our Summary of Recommendations. Part III describes relevant background. Part IV addresses issues regarding satisfying the contribution to capital and other Section 108(e)(6) requirements. Part V addresses the interaction among the provisions described above.

II. SUMMARY OF RECOMMENDATIONS

This Report makes the following recommendations for regulations or other guidance under Section 108(e)(6):

A. Shareholder Capacity and the Dominant Motivation Inquiry

1. We recommend that Treasury and the IRS confirm the requirement of Section 108(e)(6) that the debt be contributed by a "shareholder" in its capacity as such is a formal status determination, consistent with *Southwest Consolidated*,[5] requiring the contributor to actually own an instrument properly classified as equity for federal income tax purposes at the moment of contribution regardless of its characterization under applicable state or foreign law.

2. We recommend that Treasury and the IRS adopt the dominant-motivation test discussed in Part IV.A.2 as the operative test for determining whether a shareholder-creditor ("Shareholder-Creditor") has made a qualifying contribution to capital in its capacity as a shareholder for purposes of Section 108(e)(6). Whether a contribution to capital is made in a holder's shareholder capacity should be determined on an all-or-nothing basis, with no bifurcation of a single debt contribution between shareholder and creditor capacities.

B. Gratuitousness and Equity Uplift

1. We recommend that, as a threshold matter, Treasury and the IRS confirm in guidance that the form of a capital contribution, or of an exchange of debt for the issuance of equity, generally should be respected. Accordingly, where no formal equity is in fact issued to the contributing shareholder, no formal equity should be deemed issued, and the transfer should be eligible for Section 108(e)(6). Where formal equity is in fact issued and the value of the equity issued equals the value of the debt exchanged therefor, the issuance should be respected and treated as within Section 108(e)(8). That treatment applies even where the contributor wholly owns the debtor.

2. Where a debt instrument is exchanged for consideration in form, but the value of the consideration received (even if in the form of stock) is less than the value of the debt exchanged, we recommend that, as a threshold matter,

[5] *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

substance-over-form principles apply to characterize the transaction as a partial contribution and a partial exchange and the transaction as so characterized should then be analyzed as described in Part V.

3. We recommend that Treasury and the IRS clarify, consistent with *Fink*[6], that a non-pro rata capital contribution is not disqualified from Section 108(e)(6) because it incidentally benefits non-contributing shareholders, and that any recast under Revenue Ruling 73-233[7] operates at the shareholder level without disqualifying the transaction under Section 108(e)(6) at the corporate level.

4. We recommend that Treasury and the IRS provide guidance that concurrent corporate-level transactions affecting other parties' equity or debt do not, by themselves, disqualify a debt-to-capital contribution from Section 108(e)(6) treatment merely because they increase the contributor's stock ownership—subject to the dominant motivation test and general tax principles, including substance-over-form principles.

C. Threshold Conditions on the Contributed Debt

1. We recommend that Treasury and the IRS make clear in guidance that Section 108(e)(6) requires the contributed debt to have value — whether current liquidating value or "potential value" within the meaning of *Morton*[8] (which can be derivative of its ability to delay or "hold up" the implementation of a restructuring transaction) — at the time of contribution, and provide guidance adopting the worthlessness standard of *Morton* as implemented through Sections 165(g) and 166 as the applicable standard for this condition.

2. We recommend that Treasury and the IRS provide guidance that no balance-sheet (or similar) solvency threshold, whether measured before or after the contribution, applies as an independent limitation on Section 108(e)(6), and that the approach in FSA 199915005[9] not be adopted. The dominant motivation test alone is sufficient to enforce the policies of Section 108(e)(6), without a bright-line requirement of post-contribution solvency or minimum equity value on a fair market value basis. If Treasury and the IRS nonetheless believe an explicit post-contribution equity-value requirement is appropriate, they should consider requiring only that the

[6] *Commissioner v. Fink*, 483 U.S. 89 (1987).

[7] 1973-1 C.B. 179.

[8] *Morton v. Commissioner*, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940).

[9] (Dec. 17, 1998).

contribution create or increase either the current liquidating value or the "potential value" of the corporation's equity, measured at fair market value.

D. Interaction Among Sections 108(e)(6), 108(e)(8), and 108(e)(10)

1. We recommend that Treasury and the IRS provide guidance that a single debt instrument can be divided, such that only a portion can be contributed by a shareholder to the capital of the corporation in a transaction governed by Section 108(e)(6), and the remaining portion can be retained by the shareholder or exchanged in a transaction governed by Sections 108(e)(8) or (e)(10).

2. We recommend that Treasury and the IRS provide guidance that, where a single debt instrument is divided and only a portion is contributed to capital, the instrument's basis and AIP be allocated ratably between the contributed and retained portions.

3. Assuming Treasury and the IRS agree that a single debt instrument can be divided, Section 108(e)(6) should govern the contributed portion and no Section 108(e)(10) deemed exchange under Treas. Reg. § 1.1001-3 should be triggered on the retained portion where there are no significant modifications made to the terms of the retained portion.

4. Where part of a debt is contributed to capital and the remainder is significantly modified within the meaning of Treas. Reg. § 1.1001-3 testing the remainder as a separate instrument, the contributed portion should be eligible for capital contribution treatment under Section 108(e)(6) and the retained portion should be deemed exchanged for a new debt instrument under Section 108(e)(10).

III. BACKGROUND

A. Pre-1954 Era: The Common Law Contribution-to-Capital Doctrine

Long before any statutory codification, courts recognized that a shareholder's voluntary transfer of money or property to a corporation, without receipt of additional shares or other consideration, was not income to the corporation but rather an addition to capital.[10] The pre-Code case law drew a consistent line between contributions from shareholders (treated as an additional price paid for the existing equity investment, and therefore nontaxable) and contributions by non-shareholders (such as government subsidies or civic-group inducements), which were potentially

[10] *See United States v. Oregon-Washington R.R. & Navigation Co.*, 251 F. 211, 213 (2d Cir. 1918) ("the cancellation of the debt was a means of contribution to its capital account, quite as though the money had been contributed by the stockholder only to enhance the value of his stock").

taxable absent qualification under judicial tests focused on purpose and benefit.[11] Although the doctrine is called "contribution to capital," no formal transfer of property is required. A shareholder's gratuitous cancellation or forgiveness of a corporate debt — without any affirmative transfer of an asset — constitutes a contribution to capital under the established case law and, as later codified, under Treas. Reg. § 1.61-12(a); the substance of the transaction controls, not its form. Section 108(e)(6) reflects this directly: the statute applies when a debtor corporation "acquires its indebtedness from a shareholder as a contribution to capital" — language that describes the extinguishment of a debt obligation rather than the transfer of property. The treatment of non-shareholder contributions was less certain, with courts struggling to distinguish inducement payments that merely compensated the corporation for locating or expanding its operations from genuine additions to capital.

B. The 1954 Code: Sections 118, 351, and 362

The Internal Revenue Code of 1954 codified the pre-existing judicial rules in Section 118(a), which provides that "in the case of a corporation, gross income shall not include any contribution to the capital of the taxpayer." The legislative history confirms that Section 118 was intended to place "in the Code the court decisions" on this subject, principally the non-shareholder contribution cases.[12] Shareholder contributions had always been nontaxable and were not in doubt; the primary purpose of Section 118 was to extend statutory certainty to the more contested terrain of non-shareholder contributions. Section 118 contains no minimum-ownership threshold; a shareholder of any ownership percentage may make a valid contribution to capital.

Section 351 was also codified in its modern form as part of the 1954 Code, providing for nonrecognition on property transfers in exchange for stock where the transferor(s) are in control (80%) immediately after the exchange. Where the property contributed is debt of the transferee, Section 351(d)(2) further requires that the debt qualify as a "security" within the meaning of that section. The coexistence of Section 351 and Section 118 reinforces the difference between a contribution for stock (governed by Section 351, with its minimum-ownership and security

[11] *Cf. Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950) (community payments to entice factory location, nontaxable capital contributions) and *Edwards v. Cuba Railroad Co.*, 268 U.S. 628 (1925) (government subsidy payments used for capital expenditures, held not to constitute income within the meaning of the Sixteenth Amendment) *with Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943) (customer payments for utility line extensions were neither gifts nor contributions to capital, and therefore did not give rise to a depreciable basis in the utility's hands).

[12] H.R. Rep. No. 83-1337, at 17 (1954)("Your committee's bill provides that in the case of a corporation, gross income is not to include any contribution to the capital of the taxpayer. This in effect places in the code the court decisions on this subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services. Under your committee's bill the basis of property representing contributions to operating facilities, as contrasted to the basis of property representing contributions to capital, is to be zero. In this manner an income tax will eventually be paid with respect to contributions for operating facilities either in the form of a larger capital gain than would otherwise occur if the corporation sells the property, or by a smaller depreciation deduction, if the property is used in the corporation's trade or business."); S. Rep. No. 83-1622, at 18 (1954) (similar).

requirements and its exchange mechanics) and a contribution without stock (governed by Section 118 and Section 362(a)(2)).[13] This structural distinction argues against importing either a minimum-ownership threshold or a security requirement into Section 108(e)(6) by analogy to Section 351.

Congress paired the Section 118 income exclusion with Section 362 basis rules. Under Section 362(a)(2), the corporation takes carryover basis in property acquired as a shareholder contribution to capital. Congress added Section 362(c) to eliminate the double benefit (i.e., income exclusion plus depreciable basis) that *Brown Shoe*[14] and similar cases would have otherwise produced. The "as such" language of Section 362(c)(1)(B) draws the relevant line (i.e., a contribution "by a shareholder as such" is one made in the contributor's capacity as an equity holder with a continuing stake in the enterprise).[15] The carryover-basis rule is presumably appropriate because the shareholder's continuing equity interest demonstrates an intent to benefit the corporate enterprise as an ongoing investment rather than merely to obtain a specific commercial benefit.

The coexistence of Sections 118 and 362(c)(1)(B) also reinforces the importance of contributor status. The dual-capacity question, where a person acts simultaneously as shareholder and in another capacity (creditor, service provider, or civic participant), is not novel. Courts have addressed analogous issues in other contexts where a person's dominant capacity must be identified.[16] In the capital-contribution context, the critical issue is whether the contributor's dominant motivation is equity based (which supports carryover basis and deferral of loss recognition to a future disposition event) or commercially non-equity driven (which yields current income recognition and no basis credit).

C. Between 1954 and 1980: Developments and Testing Boundaries

Despite the 1954 framework, a critical gap remained. Section 118 excluded contributions to capital from corporate income but did not address the asymmetric tax benefit created when a cash-method shareholder, who had never included the item in income, forgave a debt that an accrual-method corporation had previously deducted. In that configuration, the corporation obtained a deduction for an expense it never paid, and when the shareholder forgave the debt,

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[13] *See* I.R.C. Section 118(a), 351(a); *cf.* I.R.C. Section 362(c)(1)(B) (the "as such" basis rule contains no minimum-ownership-percentage requirement). Notably, Section 351 operates primarily to protect the contributor from gaining recognition on a transfer to a controlled corporation, whereas Sections 118 and 108(e)(6) operate primarily to protect the transferee corporation from income recognition, a distinction that bears on whether control-type requirements appropriate under Section 351 should be imported into the Section 108(e)(6) analysis.

[14] *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950); I.R.C. Section 362(c).

[15] *See* I.R.C. Section 362(c)(1)(B) (providing zero basis for property contributed by "a person who is not a shareholder as such"). The phrase "as such" draws the line between contributions made in the contributor's equity capacity (which results in carryover basis) and contributions made in other capacities, which results in zero basis.

[16] The dual-capacity issue arises in other contexts in the tax law and is sometimes resolved by identifying the dominant capacity or purpose of the transfer. *See, e.g.*, *Commissioner v. Duberstein*, 363 U.S. 278 (1960) (dominant reason inquiry for gift vs. compensation).

neither party paid tax (i.e., the shareholder had never recognized income, and the corporation was shielded by Section 118).[17] Section 362(c)'s zero-basis rule was inapplicable because the contributing party was a shareholder. This gap prompted Congress to enact Section 108(e)(6) in 1980.

Treas. Reg. § 1.61-12(a) provides that a shareholder's forgiveness of a corporate debt constitutes a contribution to capital "to the extent of the principal of the debt" where the forgiveness is "gratuitous." The term "gratuitous" in this context means simply that the transfer is made without quid pro quo or bargained for consideration, and the contributor does not receive full fair market value ("FMV") in exchange for the debt or asset contributed, not that the contributor lacks all self-interested motive. A shareholder who forgives a corporate debt to protect or enhance the value of its equity investment is acting gratuitously in the capital-contribution sense even though its dominant motive is purely economic self-interest.[18] *Duberstein*[19] confirmed the dominant-motive standard, establishing that the controlling inquiry is the transferor's basic reason for acting, not the presence or absence of economic self-interest, and that a transfer driven primarily by a desire to benefit or protect one's equity investment is not a gift in the statutory sense but is also not necessarily taxable where it is made in a capacity the law treats as nontaxable.

A parallel body of pre-statutory case law developed the contribution-to-capital characterization on the creditor side, addressing whether a Shareholder-Creditor's forgiveness of a corporate debt foreclosed a deduction under Section 166 by virtue of constituting a contribution to capital. The leading authorities include *Lidgerwood*, *Krueger*, *Bratton*, *Perlman*, *Mayo*, and *Giblin*.[20] Each addressed whether the transaction was properly characterized as a contribution to capital (with the consequence that no Section 166 deduction was available to the creditor) or as a bad debt (with a deduction available subject to the requirements of Section 166). Where the courts applied the contribution-to-capital characterization (*Lidgerwood*, *Krueger*, *Bratton*, and *Perlman*), the result was adverse to the creditor by foreclosing the Section 166 deduction; where the courts rejected it on the specific facts (*Mayo* and *Giblin*), the creditor obtained the Section 166 deduction. The characterization itself is symmetrical: a transaction that is a contribution to capital for purposes of denying the creditor's Section 166 deduction is also a contribution to capital for purposes of measuring the debtor's income under what is now Section 108(e)(6). The coordination of Section 108(e)(6) with Section 166 (and with Section 165(g)) is addressed in further detail in Part III.G below.

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[17] *See Putoma Corp. v. Commissioner*, 66 T.C. 652, 668 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

[18] *See Commissioner v. Fink*, 483 U.S. 89, 96-97 (1987); *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (the controlling inquiry under the dominant-motive standard is the transferor's basic reason for acting, not the presence or absence of economic self-interest).

[19] *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960).

[20] *Lidgerwood Manufacturing Co. v. Commissioner*, 22 T.C. 1152 (1954), *aff'd*, 229 F.2d 241 (2d Cir. 1956); W.A. *Krueger Co. v. Commissioner*, 26 T.C.M. (CCH) 946, T.C. Memo. 1967-192; *Bratton v. Commissioner*, 217 F.2d 486 (6th Cir. 1954); *Perlman v. Commissioner*, 27 T.C. 755 (1957), *aff'd*, 252 F.2d 890 (2d Cir. 1958); *Mayo v. Commissioner*, T.C. Memo. 1957-9; *Giblin v. Commissioner*, 227 F.2d 692 (5th Cir. 1955).

Fink[21] illustrates the gratuitous-but-not-donative principle. Two dominant shareholders surrendered stock non-pro rata, receiving nothing in exchange, to make the corporation more attractive to outside investors and preserve the value of their retained holdings. The Court held the surrender was a nontaxable contribution to capital, not a deductible loss, because the benefit to the contributing shareholders was generalized, as they stood to gain only from the overall improvement in the corporation's financial position, not from any specific, directed transfer of value to identified third parties. The Court analogized the stock surrender directly to a Shareholder-Creditor's contribution of a corporate debt to capital.[22]

Revenue Ruling 73-233[23] presents the important contrast. In that ruling, the majority shareholder of a corporation with three shareholders, A (60%), B (20%), and C (20%), agreed, as consideration for B and C voting in favor of a merger, to contribute one-third of its X stock to the capital of X, thereby equalizing ownership at 50/25/25 and enabling B and C to receive 25 shares (rather than 20) of the acquirer's stock. The Service recast the transaction as a pro rata exchange in the merger plus a separate taxable payment by A to B and C for their votes. The key distinguishing feature from *Fink* was that the majority shareholder was conferring a special, particularized benefit on identified third parties in exchange for a specific concession, not making a generalized investment in the corporate entity.

D. The 1980 Bankruptcy Tax Act: Enactment of Section 108(e)(6)

Congress enacted Section 108(e)(6) as part of the Bankruptcy Tax Act of 1980[24] to provide a statutory framework for the tax treatment of discharge of indebtedness and, specifically, to reverse the result in *Putoma*.[25] The Senate Finance Committee Report ("1980 Senate Report") stated that the provision was designed to address the situation in which "a cash-basis taxpayer contributes to the capital of an accrual-basis corporation a debt representing an accrued expense previously deducted by the corporation."[26]

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[21] Although *Fink* was decided in 1987, after the enactment of Section 108(e)(6), the Court's analysis rested entirely on pre-statutory contribution-to-capital principles, and the decision is properly understood as confirming and elaborating those principles rather than establishing new law.

[22] *Id.* at 94, 100 (The Court makes a direct analogy between a stock surrender and a "creditor-shareholder who forgives the corporation's debt," citing Section 263 and Reg. Section 1.61-12(a)).

[23] 1973-1 C.B. 179.

[24] 1980 Act.

[25] *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

[26] Rep. No. 96-1035, 96th Cong., 2d Sess. (1980), *reprinted in* 1980-2 C.B. 620 at 19 n.22: "This contribution-to-capital rule reverses the result reached in *Putoma Corp. v. Comm'r*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979). Moreover, it is intended that the result reached in Putoma could not alternatively be sustained on the ground that the shareholder has made a "gift" to the corporation, since it is intended that there will not be any gift exception in a commercial context (such as a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness. *Whether a cancellation of indebtedness by a Shareholder-Creditor is a contribution to capital depends upon the facts of the particular case. In order for the contribution to capital rule to apply, the shareholder's action in cancelling the debt must be related to his status as a shareholder. If the Shareholder-Creditor*

In addition, the 1980 Senate Report provided that the *Putoma* result could not be sustained on the ground that the shareholder has made a gift to the corporation since there is no gift exception in a commercial context (such as a shareholder-corporation relationship). Correspondingly, the 1980 Senate Report reinforces that a contribution to capital and a gift are not the same thing and should not be treated as partially overlapping. A contribution to capital rolls into existing equity; if the amount contributed exceeds the benefit received by the contributor with respect to its equity position, the difference is not recast as a tax-free gift to the corporation. Once a transaction is identified as commercial, there should be no bifurcation between the contribution-to-capital and gift analyses.

The entire arc of the contribution-to-capital doctrine, from the pre-Code cases through Section 118, Section 362, and Section 108(e)(6), reflects a consistent focus on the capacity in which a transfer is made. Transfers made in the capacity of a shareholder (who has a continuing investment interest in the enterprise) are nontaxable; transfers made in the capacity of a service provider, customer, government, or arm's-length creditor may be taxable.

The *Putoma* court addressed a contributor who held three roles: service provider (for accrued salary), creditor (for the accrued obligation), and shareholder. One interpretation is that the 1980 Act generally resolved in favor of shareholder status (declining to impose CODI), except to the extent the IRS was whipsawed (i.e., where the shareholder had not taken the income into account but the corporation had already deducted it). The 1980 Senate Report adds a caution specifically directed at the creditor capacity: a shareholder acting to maximize creditor recovery is not acting in the shareholder capacity for purposes of Section 108(e)(6). This underlines the difficulty presented by a contributor acting under multiple capacities — illustrating that the line between these capacities is not always bright.

The 1980 Senate Report identified a key limitation: the provision applies only where the contributing shareholder acts "as a shareholder," not "merely as a creditor" seeking to maximize its recovery on a debt investment.[27] It illustrated the boundary by reference to publicly traded stocks and bonds (e.g., a bondholder who merely happened also to own some publicly traded shares would not be acting as a shareholder for purposes of the provision). Section 108(e)(4), which governs related-party acquisitions of debt and resets the AIP, was codified as part of the 1980 Act, reflecting Congress's recognition that a shareholder may acquire debt in the secondary market prior to a Section 108(e)(6) contribution, provided that the basis-reset mechanism operates correctly to prevent a double benefit or detriment.[28] The 1980 Act also enacted Section 108(e)(8)

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acts merely as a creditor attempting to maximize the satisfaction of a claim, such as where the stock and bonds are publicly held and the creditor simply happens also to be a shareholder, the cancellation of the indebtedness on exchange of the bonds for stock is not to be treated as a contribution to capital by a shareholder for purposes of this rule." [Emphasis added].

[27] 1980 Senate Report at 19 n.22.

[28] *See* Section 108(e)(4) (providing for deemed reissuance of debt acquired by a related party at a discount, thereby resetting AIP and shareholder basis). Where Section 108(e)(4) applies, it produces CODI at acquisition and resets the AIP; a subsequent Section 108(e)(6) contribution is based on the reset basis, ensuring no double benefit or detriment. 1980 Senate Report at 19 n.23 provides that: "[T]he Treasury Department has authority to and will issue regulations

as a de minimis carve-out from the then-judicial stock-for-debt exception, denying that exception where only nominal or token shares were issued in satisfaction of debt.

The mechanics of Section 108(e)(6) as enacted were simple: Section 118 does not apply; instead, for purposes of determining the corporation's CODI, the corporation is treated as having satisfied the debt with cash equal to the shareholder's adjusted basis.[29] Where basis equals AIP, no CODI results. Where basis is less than AIP, as in the *Putoma* fact pattern, the difference is CODI. In essence, Section 108(e)(6) functions like a carryover-basis rule analogous to Section 362(a)(2): since the debt is extinguished rather than held as an asset by the corporation, the shareholder's basis in the debt is matched against the debt's AIP to determine whether any income should be recognized.

E. Post-1980 Developments: The 1993 Repeal and Recent Section 118 Amendments

Three statutory developments after 1980 reshaped the framework within which Section 108(e)(6) operates. The Deficit Reduction Act of 1984 ("1984 Act") enacted Section 108(e)(10), reversing the prior default: whereas the broad judicial stock-for-debt exception had generally treated a debtor's satisfaction of indebtedness through stock issuance as nontaxable, the 1984 Act established CODI recognition as the general rule — measured by the FMV of the stock issued — while preserving the prior no-CODI result as a statutory exception for corporations in a Title 11

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providing for the following income tax consequences on repayment or capital contribution of debt which had been acquired by a related party subject to the rule of the bill treating the debtor as having acquired the debt. If the debtor subsequently pays the debt to the related party, the entire transaction is to be treated generally the same as if the debtor had originally acquired the debt. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year when the debt matures, assume the subsidiary pays its parent the full principal amount ($1,000). The Treasury regulations are to provide that the debtor is treated as having paid a dividend of $100 ($1,000 payment to the parent less the $900 paid by the parent to acquire the debt) to its parent corporation. If a related party transfers to a corporation as a contribution to capital debt issued by the corporation and the debtor corporation thereby would otherwise have a debt discharge amount pursuant to the rules of the bill, the bill provides that no such income shall arise a second time. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year, assume the parent transfers the debt to its subsidiary as a contribution to capital (i.e., forgives the debt). The Treasury regulations are to provide that the amount treated as a debt discharge amount under the capital contribution rules of the bill ($100 in the example given, assuming the parent's basis in the bond is still $900) is to be reduced by the debt discharge amount previously taken into account by the subsidiary ($100) and thus no additional amount is to be taken into income." *See also* Treas. Reg. § 1.108-2(g)(4), Example 3. This Report is not intended to focus on issues between the interaction of Section 108(e)(6) and 108(e)(4).

[29] The full text of Section 108(e)(6): "Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital: (A) section 118 shall not apply, but (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness." The displacement of Section 118 is surgical: it applies only to the shareholder-debt-contribution context; for all other shareholder contributions, Section 118 continues to govern.

case or that were insolvent and for certain qualified workouts.[30] Section 108(e)(8), which had been enacted by the 1980 Act as a de minimis carve-out denying the stock-for-debt exception where only nominal or token shares were issued, continued to serve that function.[31] The Omnibus Budget Reconciliation Act of 1990 added debt-for-debt exchange rules at Section 108(e)(11).[32] The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") repealed Section 108(e)(10) in its entirety, eliminating both the general FMV recognition rule and its built-in exceptions; rewrote Section 108(e)(8) as the general rule governing all stock-for-debt exchanges, measured by the FMV of stock issued; and renumbered the 1990 debt-for-debt rules from Section 108(e)(11) to the vacated Section 108(e)(10).[33] The 1993 Act also amended Section 108(e)(6) by adding the prefatory clause "Except as provided in regulations," authorizing Treasury to issue coordination regulations, and the Conference Report expressly directed that such regulations be issued.[34] To date, no Treasury Regulations have been promulgated. After 1993, a transaction falling outside Section 108(e)(6) and within Section 108(e)(8) produces CODI measured by the excess of the debt's AIP over the FMV of stock issued, an outcome that can be materially more adverse to the debtor. The unresolved interpretive issues under Section 108(e)(6) thus carry substantially greater stakes than they did when the provision was first enacted.

Section 118's scope has been further narrowed by the Tax Cuts and Jobs Act of 2017 ("TCJA"), which excluded from Section 118(a) contributions by any governmental entity or civic

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[30] Pub. L. No. 98-369, section 59(a), 98 Stat. 576 (1984) (adding Section 108(e)(10)). The new provision provided: "(A) IN GENERAL.—For purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the FMV of the stock. (B) EXCEPTION FOR TITLE 11 CASES AND INSOLVENT DEBTORS.—Subparagraph (A) shall not apply in the case of a debtor in a title 11 case or to the extent the debtor is insolvent." Section 108(e)(10)(C), added by the same Act, provided a further exception for transfers of stock in a qualified workout meeting specified conditions. The legislative history explained that COD income should be recognized because the same amount would be recognized if the corporation issued stock for cash and used the cash to discharge the debt. H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1201-02 (1984).

[31] The 1980 Act had enacted Section 108(e)(8) under the heading "STOCK FOR DEBT EXCEPTION NOT TO APPLY IN DE MINIMIS CASES," denying the stock-for-debt exception for nominal or token share issuances and, with respect to unsecured creditors under certain circumstances. Pub. L. No. 96-589, Section 2(a), 94 Stat. 3389 (1980). The 1984 Act did not amend Section 108(e)(8); its de minimis limitations continued to apply to exchanges by bankrupt and insolvent debtors qualifying under the new Section 108(e)(10)(B) exception.

[32] Pub. L. No. 101-508, Section 11325(a), 104 Stat. 1388 (1990). The provision treats a debtor that issues a new debt instrument in satisfaction of its indebtedness as having satisfied the indebtedness with an amount of money equal to the issue price of the new instrument.

[33] Pub. L. No. 103-66, Section 13226(a)(1), 107 Stat. 488 (1993) (repealing Section 108(e)(10), rewriting Section 108(e)(8), and renumbering the 1990 debt-for-debt rules from Section 108(e)(11) to Section 108(e)(10)).

[34] Pub. L. No. 103-66, Section 13226(a)(2)(B), 107 Stat. 488 (1993) (amending Section 108(e)(6) to add the introductory clause "Except as provided in regulations"); H.R. Conf. Rep. No. 103-213, at 620 (1993) ("The conference agreement provides authority to the Treasury Department to promulgate such regulations as are necessary to coordinate the present-law rules regarding the acquisition by a corporation of its debt from a shareholder as a contribution to capital ... with the repeal of the stock-for-debt exception.").

group (other than a contribution made by a shareholder as such).[35] This amendment, which responded to concerns about economic development subsidies from state and local governments, further confirms that the shareholder-as-such distinction remains the central organizing principle of the contribution-to-capital doctrine: it is precisely the contributor's status as an equity holder, rather than, for instance, as a government, civic booster, customer, service provider, or creditor, that justifies the exclusion from income and the carryover basis treatment.

F. Conceptual Underpinnings: Two Components of a Continuing Investment

Section 108(e)(6) rests on a conceptual foundation that the contribution of the debt to capital is a decision by an investor to reconstitute the form of its investment, collapsing the senior component into the junior, in order to preserve and continue the investment in the form of equity. The transaction is gratuitous in the contribution-to-capital sense (i.e., the contributor receives no bargained-for consideration from the corporation) precisely because the contributor's motivation is the benefit to its continuing equity position rather than the extraction of value from its creditor position. Where a contributor is instead acting to realize value on its creditor position — for example, by receiving cash, new debt, or other non-equity consideration in exchange for the debt, or by compromising part of a claim to improve recovery on the remainder — the gratuitousness premise is absent as to that portion and the transaction is governed by other provisions to that extent. The shareholder-capacity requirement should enforce that boundary: a contributor acting primarily for the benefit of a continuing equity investment should be treated as acting as a shareholder; a contributor acting primarily to maximize recovery on a creditor claim, or to exit the investment entirely, should not.[36]

Every contribution of debt to capital, as a definitional matter, should increase the net equity value of the debtor corporation: the contributed debt is an asset transferred to the corporation, which uses it to eliminate a corresponding liability, and that increase in value accrues to the existing equity holders. Because Section 108(e)(6) does not contemplate, and the structure of the provision affirmatively precludes, the issuance of new shares to the contributing shareholder, the contributor can capture that uplift only through a pre-existing equity position. A contributor that

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[35] I.R.C. Section 118(b)(2), as amended by Pub. L. No. 115-97, Section 13312(a)(1)-(3) (2017). The House bill accompanying the TCJA proposed a comprehensive revision of the contribution-to-capital rules that would have made all contributions to capital includible in gross income (with an exception for contributions in exchange for stock), repealed Section 118 entirely, and repealed Section 108(e)(6) as a conforming amendment. *See* H.R. 1, 115th Cong. section 3304(a), (c)(1)–(2) (2017). However, the Senate bill did not include a comparable provision, and Section 108(e)(6) survived intact. The enacted amendment's express carve-out for contributions made "by a shareholder as such" further reinforces that the shareholder-capacity requirement is the cornerstone of the contribution-to-capital doctrine.

[36] The "as though cash contributed" framing originates in *United States v. Oregon-Washington R.R. & Navigation Co.*, 251 F. 211, 213 (2d Cir. 1918) ("a means of contribution to [the corporation's] capital account, quite as though the money had been contributed by the stockholder only to enhance the value of his stock"), and is carried forward in the statutory formulation of Section 108(e)(6)(B) and in the Senate Finance Committee's description of the mechanic as treating the corporation as having "satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the debt." The Senate Report at 19. *See also Putoma Corp. v. Commissioner*, 66 T.C. 652, 668 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

holds no equity has no stake through which to benefit from that uplift; the shareholder-capacity requirement addresses this directly since such a contributor cannot be acting for the benefit of a continuing equity investment. And even if capacity were somehow established, the gratuitousness requirement should independently bar the contribution: since no new shares can be issued, there is no equity position to which the contributed debt's basis could attach and no mechanism through which the contributor could capture the value it has just transferred to others. Where the contributor retains a portion of its debt, some of the value produced by the contribution may instead be captured as an enhancement in the value of that retained debt rather than through the equity position; whether the value arising from the contribution accrues principally to retained equity or to retained debt is a factor in evaluating the Shareholder-Creditor's motivation.

Where a related contributor acquired the debt in the secondary market, Section 108(e)(4) resets the AIP to align it with the contributor's acquisition cost before the contribution occurs, preserving the basis-matching logic within that framework.[37] The basis mechanic functions as a tax-history matching rule: the corporation recognizes CODI only to the extent the contributing shareholder's adjusted basis in the debt falls short of its AIP, ensuring that the debtor's income recognition tracks the shareholder's unrecovered tax cost in the debt component of the investment. The mechanics of that matching principle, and its interaction with the worthlessness standards of Sections 165(g) and 166, are discussed in Part III.G below.

G. Coordination of Section 108(e)(6) with Sections 166 and 165(g)

Section 108(e)(6) does not operate in isolation. Its basis-measurement mechanic at the corporate level is one component that operates in tandem with the contributing holder's tax accounting for its debt investment, including the partial or complete write-off of the investment as worthless.

1. The operative creditor-side regime.

As a threshold matter, the operative creditor-side regime depends on the form of the debt. Section 166 governs a creditor's deduction for any debt that becomes worthless, with a partial-worthlessness deduction available for business bad debts under Section 166(a)(2). Section 166(e), however, removes from the scope of Section 166 any debt that constitutes a "security" within the meaning of Section 165(g)(2)(C), which includes a bond, debenture, note, certificate, or other evidence of indebtedness issued by a corporation or government or political subdivision thereof with interest coupons or in registered form. Losses on debt instruments meeting that description are governed instead by Section 165(g), which (i) requires complete worthlessness, with no provision for a partial deduction, and (ii) generally treats the loss as a capital loss, with the Section 165(g)(3) affiliated-corporation exception providing for ordinary treatment in certain circumstances. As a practical matter, much shareholder-held corporate debt implicated in Section 108(e)(6) transactions falls within Section 165(g)(2)(C); closely held shareholder loans documented as simple promissory notes without interest coupons or registration may not. The

[37] 1980 Senate Report at 19 n.23; Treas. Reg. § 1.108-2(g)(4), Example 3.

choice of instrument affects the character of any loss and the availability of a partial-worthlessness deduction but does not alter the substantive worthlessness inquiry.

2. Pre-contribution: creditor-side coordination.

Section 108(e)(6) was enacted in response to *Putoma* to address a specific configuration in which a cash-method shareholder forgave a corporate debt representing an item the accrual-method corporation had previously deducted but the shareholder had never included in income. The legislative concern was that the corporation's prior deduction would not be matched by any inclusion at the shareholder level, producing a permanent tax benefit on a pure timing arbitrage between accounting methods. Section 108(e)(6)'s basis-measurement mechanic addresses that concern directly: where the shareholder has not included the item in income, the shareholder's basis in the debt is correspondingly low, and the contribution produces CODI in the amount of the unincluded accrual. This anti-whipsaw symmetry is a textually grounded purpose of the provision identified in the 1980 Senate Report.

A related symmetry operates with respect to the contributing shareholder's tax history in the partial-worthlessness and complete worthlessness configuration that is available under Section 165(g) and Section 166. Where a Shareholder-Creditor has previously claimed a Section 166 partial bad-debt deduction with respect to the contributed debt — which, as noted, is available only for business bad debts that are not Section 165(g)(2)(C) securities — that deduction reduces the shareholder's basis in the debt under Section 1016(a).[38] On a subsequent contribution to capital, Section 108(e)(6)(B) measures the deemed satisfaction by reference to that reduced basis, with the result that the corporation recognizes CODI in the amount of the previously deducted loss. This basis-floor symmetry prevents the creditor's deduction and the debtor's exclusion from operating on the same accruing item.[39]

A more complex set of issues arises where the contributed debt is properly characterized as wholly worthless under Section 165(g) or Section 166. The substantive content of that determination, its interaction with the contribution-to-capital predicate, and the standards under Section 165(g) and Section 166 that articulate it are discussed in Part IV.C.1 below.

3. Post-contribution: shareholder-side coordination.

The contribution-to-capital doctrine rests on the premise that a shareholder's transfer to the corporation is a reconstitution of a continuing investment, rather than a market-priced exchange as

[38] Section 1016(a)(1); *see also* Section 166(b) (bad debt deduction limited to adjusted basis in the debt).

[39] For the avoidance of doubt, the contribution to capital does not by itself foreclose the contributing shareholder's ability to claim a deduction under Section 165(g) or Section 166 with respect to the contributed debt where the applicable requirements are independently satisfied and the deduction has not previously been claimed. Where, for example, the contributed debt is wholly worthless in the year of contribution, the shareholder may be entitled to claim a worthlessness deduction in that year (subject to the timing rules described in the text), with a corresponding reduction to basis that informs the Section 108(e)(6)(B) measurement on the same facts. The deduction and the contribution are tested under their respective governing standards; Section 108(e)(6) does not itself operate to deny or accelerate either.

discussed in Part III.F above. Treas. Reg. § 1.118-1 articulates the principle directly: voluntary shareholder payments "represent an additional price paid for" the contributor's existing shares. *Fink* applied the same principle in the stock-surrender context, and the pre-statutory case law on Shareholder-Creditor debt cancellations — *Lidgerwood* and *Krueger* — applied it in the debt-contribution context: the cancellation forecloses any current creditor-level deduction, with the contributor's unrecovered tax cost preserved at the equity level for recognition only when the investment is closed out.

The Code implements this framework through two coordinated mechanics. At the corporate level, Section 108(e)(6)(B) measures the deemed satisfaction by reference to the contributor's adjusted basis, so that no CODI arises where basis equals AIP. The debt component's tax history is preserved rather than extinguished. At the shareholder level, Section 1016(a)(1) increases the contributor's stock basis by the same amount, migrating the tax cost of the debt component into the surviving equity component.[40] The paradigm case illustrates the symmetry: a shareholder that funds the corporation with $100 of debt, watches the debt decline in value to $20 as the business reverses, and contributes the debt to capital recognizes no CODI, takes a $100 stock-basis increase, and preserves its $80 of unrecovered economic loss at the equity level. This result reflects the continuing-investment premise of the codified case law: the contribution is not the appropriate moment to measure gain or loss because the shareholder's investment has not been closed out — the debt component has been reconstituted into the equity component, and the ultimate value of that equity remains to be determined by the future performance of the enterprise or a later sale. The profile is the same as would have applied had the investment been made in equity form at the outset.

Consistent with the anti-*Putoma* symmetry, Section 108(e)(6) generates CODI only where the shareholder holds the debt at a basis below AIP, which may reflect either an item the corporation deducted but the shareholder never included, or a market discount where the shareholder acquired the debt below AIP and holds it at that purchase-price basis. Where basis equals AIP, Section 108(e)(6) treats the corporation as having retired the debt in full, and there is nothing to tax.

A Shareholder-Creditor's contributed debt and existing equity represent a continuing investment. The basis in each is an expression of the same original cash outlay. When the debt component is collapsed into the equity component, that basis migrates intact. Section 108(e)(6)(B) confirms the original investment was repaid in full, and Section 1016(a)(1) carries it forward in the surviving component.

IV. SATISFYING THE CONTRIBUTION TO CAPITAL AND SECTION 108(E)(6) REQUIREMENTS

Section 108(e)(6) provides, in its operative clause, that "[e]xcept as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor

[40] *See* Treas. Reg. § 1.118-1 (voluntary shareholder payments represent "an additional price paid for" the contributor's existing shares); Section 1016(a)(1) (basis adjustment for items properly chargeable to capital account); *Commissioner v. Fink*, 483 U.S. 89, 94 (1987). "Section 1016(a)(1)" is used as shorthand for this mechanic throughout.

corporation acquires its indebtedness from a shareholder as a contribution to capital," the deemed-satisfaction measurement rule applies. The provision has three operative elements: the contributor must be a shareholder of the debtor at the time of the contribution; the transfer of the debt must constitute a qualifying contribution to capital; and the corporation must acquire its own indebtedness from the shareholder, which raises distinct considerations regarding the instrument contributed and the manner in which the shareholder came to hold it. These three prerequisites (i.e., shareholder capacity, gratuitousness, and the threshold conditions on the contributed debt) are not merely formal conditions but the substantive markers that distinguish a genuine reconstitution of a continuing investment from a transaction that adopts the contribution-to-capital form without the underlying economic reality. They operate in tandem, overlapping and informing one another, and the step-transaction, economic-substance, and other generally applicable anti-abuse doctrines apply across all three and feed into the dominant-motivation inquiry discussed in Part IV.A.2.

The first two elements are in part informed by Section 118 and the contribution-to-capital case law discussed in Part III above; Section 108(e)(6) operates within the existing framework of the capital-contribution doctrine. Its core conditions — that the transaction be a qualifying contribution to capital and that the contributor act in shareholder capacity — are continuous with the structural prerequisites that the capital-contribution case law has long applied. The third element is specific to Section 108(e)(6).

This Part IV addresses each of the three elements in turn. For purposes of the examples below, "Debtor" or "D" refers to the debtor corporation.

A. Shareholder Capacity and the Dominant Motivation Inquiry

1. Shareholder requirement: formal equity and tax classification

The shareholder requirement should be a status determination made at the moment of contribution. The contributor must hold actual equity of the debtor at that moment, not merely debt. Section 108(e)(6) imposes no minimum-ownership threshold, consistent with Section 118 and the contribution-to-capital case law; a shareholder of any percentage may make a qualifying contribution, with the shareholder-capacity inquiry through a facts and circumstances dominant-motivation determination discussed in Part IV.A.2 below supplying the operative test.

The Supreme Court's decision in *Southwest Consolidated* bears directly on what satisfies the "shareholder" requirement. In that case, the Court held that while bondholders of an insolvent corporation may be treated as having "stepped into the shoes of the old stockholders" for purposes of the continuity-of-interest test under *Alabama Asphaltic*[41] — that is, for determining whether

[41] For analogous regulatory extensions of shareholder-equivalent treatment to creditors of insolvent corporations, *see* Treas. Reg. § 1.7874-2(i)(2) (inversion ownership fraction), which expressly treats creditors of an insolvent domestic corporation as shareholders for purposes of calculating the ownership fraction in the inversion context. Sections 7874(c)(6) and 7874(g) authorize Treasury to prescribe regulations determining surrogate foreign corporation status — including regulations treating non-stock interests as stock — and to adjust the application of section 7874 to prevent

creditors have acquired the proprietary interest — it is "quite another" matter to treat them as "stockholders" for purposes of a statutory provision that identifies a specific, formally defined class of security holders of the transferor corporation. Accordingly, economic-proprietorship theory should not be used to satisfy a statutory term that identifies formal security-holder status: a creditor who holds the economic equivalent of equity in an insolvent debtor should not be treated as a "shareholder" for purposes of Section 108(e)(6) absent regulatory extension or statutory amendment. We believe Section 108(e)(6) presents the same textual constraint and should not be read to incorporate constructive ownership or attribution rules. Formal equity ownership should be determined under federal income tax classification principles rather than legal form. A contributor holding an instrument not classified as equity under applicable state or foreign law but properly classified as equity for federal income tax purposes should satisfy the requirement.

We recommend that Treasury and the IRS confirm the requirement of Section 108(e)(6) that the debt be contributed by a "shareholder" in its capacity as such is a formal status determination, consistent with *Southwest Consolidated*, requiring the contributor to actually own an instrument properly classified as equity for federal income tax purposes at the moment of contribution regardless of its characterization under applicable state or foreign law.

2. Shareholder requirement: capacity

Section 108(e)(6) requires not only that the contributor hold equity of the debtor at the time of the contribution, but also that the contribution be made in the contributor's capacity as a shareholder (i.e., for the benefit of the contributor's continuing equity investment) rather than to maximize recovery on its creditor claim. The 1980 Senate Report confirms this: Section 108(e)(6) applies where the contribution is made in the contributor's capacity as a shareholder, and not where the contributor "happens to be" both a creditor and a shareholder but is acting primarily in a creditor capacity.

Whether that threshold capacity requirement is satisfied should be a facts-and-circumstances determination, applied on an all-or-nothing basis with no bifurcation of a single contribution between shareholder and creditor capacities. If more than one debt instrument is contributed, each contribution should be separately tested. The controlling question, consistent with the general approach *Duberstein* established for analogous capacity inquiries under the Code, is the transferor's basic reason for acting, assessed on the totality of the facts and circumstances at the time of the contribution.

We recommend that Treasury and the IRS adopt in guidance a "dominant-motivation" test as the operative test for determining whether a Shareholder-Creditor has made a qualifying contribution to capital in its capacity as a shareholder for purposes of Section 108(e)(6). Under the dominant-motivation test, a debt contribution potentially qualifies under Section 108(e)(6) if the Shareholder-Creditor's dominant motivations in contributing the debt to capital is related to its

avoidance of its purposes. *See* T.D. 9453, 74 Fed. Reg. 27920 (June 12, 2009); *see also* Treas. Reg. § 1.368-1(e)(6) (continuity of interest).

status as a shareholder.[42] Such guidance should provide that the dominant-motivation inquiry is informed by a list of non-exclusive factors, including the ones suggested below, and that no single factor necessarily is dispositive or establishes a bright-line minimum, arithmetic requirement. Two valuation concepts recur in the factors discussed below and should be distinguished. "Liquidating value" refers to the value that would be realized in an immediate liquidation of the debtor as of the relevant moment, without regard to the prospect of future appreciation in value. "FMV" refers to the price at which an instrument or equity interest would change hands between a willing buyer and a willing seller. It therefore reflects not only current liquidating value but also potential future value – i.e., the probability-weighted value of future recovery and other forward-looking prospects, including hold up value. FMV is accordingly equal to or greater than liquidating value, with the difference representing the option value attributable to the prospect of future appreciation. Because FMV in this sense already reflects the value (including hold up value) attributable to potential future recovery, the FMV of a contributed claim captures the upside the contributor surrenders on that claim, and that upside is not separately counted as additional value given up in applying these factors.

a. *Amount of debt contributed*. The amount of debt contributed relative to the contributor's total debt position is informative of capacity. Where the contribution consists of the contributor's entire debt position and the contributor's continuing equity has some current or forward value, that is a significant positive factor indicating that the contributor was acting in a shareholder capacity, regardless of the size of the contributor's equity stake relative to its debt position. Partial contributions occupy a spectrum: the smaller the contribution as a percentage of the contributor's total debt position, the more the transaction may take on the economic shape of a creditor's partial compromise of its claim in order to preserve the value of the remainder, but that observation operates as one factor alongside the others rather than as a counter-presumption.

b. *Current equity uplift (liquidating value) relative to the FMV of the claim surrendered*. A useful datapoint for the capacity inquiry is a comparison of the FMV of the claim being contributed (which, as noted above, captures the forward-looking upside surrendered on that claim) against the contributor's share of the current equity uplift the contribution produces, measured on a liquidating-value basis. The claim side is measured at FMV because, as noted above, FMV captures in a single figure the full value surrendered on the claim, both current and forward; the current equity uplift is measured at liquidating value, with forward-looking equity value considered separately under factor (c), because the credibility of any forward-

[42] "Whether a cancellation of indebtedness by a Shareholder-Creditor is a contribution to capital depends upon the facts of the particular case. In order for the contribution to capital rule to apply, the shareholder's action in cancelling the debt must be related to his status as a shareholder." 1980 Senate Report at 19 n.22.

looking equity expectation is the distinct question that factor addresses. *Fink* established that incidental benefit to non-contributing shareholders does not defeat contribution-to-capital characterization; the same principle applies to a contribution of debt for no consideration, so this comparison is not a threshold test but a diagnostic. The existence of equity uplift, and not merely its magnitude, is itself probative: that the contribution produces any uplift captured through the contributor's continuing equity position is evidence that the contributor is acting through, and for the benefit of, that position, even where the amount of the uplift is small relative to the claim value surrendered. However, where the contributor's share of the current equity uplift is small relative to the claim value surrendered, the shareholder-capacity explanation may rely more heavily on forward-looking equity value (addressed in factor (c)), and the other factors may carry correspondingly greater weight in the overall dominant motivation determination.

c. *Forward-looking equity value*. Beyond current liquidating value, a contributor acting in shareholder capacity may be making a forward-looking assessment: it is giving up current claim value in exchange for the prospect of future appreciation in equity value that the contribution is expected to produce by improving the debtor's capital structure, enabling continued operations, or unlocking financing. That forward-looking value may take the form of incremental improvement in the probability of future appreciation of an established business, or option value (i.e., a lower probability of a very large outcome) where the enterprise is in an early stage, pursues a novel technology or business model, or operates in a sector where the potential upside would dwarf the current value of the contributed claim. The rationality of the contribution is assessed by reference to the expected value of the equity position, not its most likely outcome. The contributor's contemporaneous projections, business plans, and restructuring analyses, prepared in the ordinary course of managing its investment rather than for tax purposes, are relevant evidence of a credible forward-looking equity-value explanation, but where the investment thesis rests on option value rather than near-term earnings, the absence of detailed financial projections is not itself disqualifying.

d. *Effect of the contribution on the contributor's creditor and equity positions*. As discussed in Part III.F, the contribution-to-capital doctrine rests on the premise that the value embodied in the contributed debt is reconstituted into the contributor's continuing equity position. This factor asks whether the value arising from the

contribution accrues principally to the contributor's retained equity or instead to its retained debt, in which case the contribution may be better characterized as a creditor's act. The contribution may create value in two forms: equity uplift, captured pro rata with other shareholders and addressed in factors (b) and (c), and creditor uplift on the retained debt position. Both should be measured on the same basis: just as factors (b) and (c) credit not only current liquidating value but also forward-looking increases in equity value the contribution is expected to produce, the measurement of creditor uplift should take into account forward-looking increases in the value of the retained debt arising for the same reasons. A contribution expected to improve the debtor's prospects enhances the expected recovery on retained debt as well as the expected value of equity, and confining the creditor-side measurement to current liquidating value would understate the creditor-side return. The contributed portion is excluded from this measurement, as its pro-rata FMV is a cost of the transaction rather than a benefit. Whether a net decline points toward shareholder capacity (a creditor maximizing recovery would not accept a net reduction in its position) or toward creditor capacity (a creditor may rationally absorb a current loss to limit deterioration in a distressed position) depends on the facts and circumstances, including where the offsetting value accrues. Where most of the contributor's return accrues as improved coverage or expected recovery on retained debt, the contribution has aspects of a creditor's partial compromise; where a significant share accrues as current or forward equity uplift (particularly where the contribution has a catalytic effect on enterprise value), the factor supports shareholder-capacity treatment. The contributor's position after the contribution is also probative. A contributor that emerges holding predominantly retained debt and only a small equity stake remains principally in creditor form, consistent with a creditor's compromise; one whose mix shifts meaningfully toward equity acts consistently with shareholder capacity. This inquiry concerns the contributor's relative debt and equity positions, not the absolute amount of debt contributed, which is addressed under factor (a). Where the contributor holds multiple tranches of the same debtor's debt, retained debt includes all retained positions, since the contribution may improve coverage across the entire retained creditor stack.[43]

[43] This factor presupposes that the FMV of the retained debt reflects credit-related factors — the debtor's financial condition, capital structure, and going-concern prospects — that the contribution is capable of affecting. Where a material portion of the FMV discount on the retained debt is attributable to factors unrelated to the debtor's credit

e. *Control and ability to assess and influence future equity value*. A contributor that holds board representation, management control, or directional influence over the debtor's restructuring plan is in a materially different position from a passive holder who merely happens to own equity alongside its debt. A controlling or actively engaged shareholder has access to proprietary financial projections, is positioned to assess whether the contribution will unlock enterprise value, and has the agency to implement the steps designed to produce that value, all of which make the forward-looking explanation under factors (c) and (d) more credible. The same influence that lets a contributor assess and shape future equity value also lets it shape the expected recovery on its retained debt, so control bears on factor (d) as well: a controlling contributor may be exercising that influence to enhance its retained creditor position rather than its equity, and the direction in which control cuts depends on which position captures the value produced. The 1980 Senate Report's publicly traded discussion appears to indicate that the paradigm case for denying shareholder-capacity treatment is the passive holder of publicly traded stocks and bonds who has none of the attributes that make a forward-looking equity-value explanation credible (which aligns control more closely with shareholder capacity treatment). Control is not a threshold requirement; a contributor without formal control can still satisfy the capacity inquiry, but the absence of control reduces the plausibility of the forward-looking creditor or equity-value explanation and shifts greater weight to the other factors.

f. *Context in which the contribution occurs*. The treatment of other creditors and shareholders is often an important circumstance bearing on whether the contribution reflects a shareholder-capacity act or a creditor's compromise. In particular, whether the contribution is proportionate to the contributor's debt holdings or instead to its equity holdings is a strong indicator of the capacity in which it acts. A contribution made pro rata in proportion to the contributors' equity holdings, irrespective of their debt holdings, supports shareholder-capacity treatment, because the contributors bear the cost in proportion to their equity rather than their creditor stakes and the pattern reflects a collective decision to strengthen the debtor's capital structure in proportion to each contributor's continuing equity investment. A contribution made pro rata to debt holdings across multiple creditors, especially when other holders of

(such as movements in general market interest rates between origination and the contribution), the creditor-uplift signal this factor identifies is correspondingly weakened.

the same debt receive stock in exchange for their debt, without regard to their relative equity positions, is more consistent with coordinated creditor-capacity behavior. Where a contributor's debt and equity ownership are closely aligned, the pro rata signal is muted, since a contribution proportionate to debt is also proportionate to equity, and the inquiry turns on the other factors. A contribution that enables the contributor to realize the equity uplift it produces, including through a subsequent sale of the contributor's equity at the post-contribution value, is consistent, rather than in tension, with the shareholder-capacity premise; a contribution should not fail to qualify under Section 108(e)(6) solely because one of its principal purposes is to facilitate an arm's-length sale or other disposition of the contributor's equity to or with an unrelated third-party following the contribution.

Separately, certain characteristics of the contributor**'**s debt and equity positions, while not individually dispositive, may be probative of the contributor**'**s dominant motivation. The holding period of the contributor**'**s debt and equity positions in the debtor, the quantum of each position relative to the other and relative to the overall capital structure, and the manner in which the contributor acquired the contributed debt and equity may be relevant factors.

g. *Outside consideration and non-equity motivations*. Where the value the contributor receives comes from the transferee corporation itself (for example, a release of claims by the corporation, the corporation's settlement of a separate liability owed to the contributor, or other non-equity consideration furnished by the corporation), there is no contribution to capital to the extent of that value, rather than merely a negative factor: value furnished by the corporation in exchange for the debt is the antithesis of a gratuitous contribution, and to that extent the transaction is an exchange or payment governed by other provisions of the Code. Where instead the contributor receives value connected to the contribution but not furnished by the corporation (including an indemnity, fee, or related-party arrangement with a person other than the corporation), that may be a negative factor bearing on capacity and warrants additional review, as does value the receipt of which the step-transaction doctrine links to the contribution. The relevant question is whether the contribution can be explained by reference to the

contributor's continuing equity interest, rather than the receipt of value outside of such continuing interest.[44]

In straightforward cases (such as a controlling shareholder contributing its entire debt position in a viable enterprise with documented equity value), the conclusion as to whether the contributor is acting in a shareholder capacity generally will be apparent from the face of the transaction. We recommend that Treasury and the IRS include in Regulations or other guidance an example illustrating that, in such straightforward cases, the shareholder-capacity conclusion is apparent from the face of the transaction without a factor-by-factor analysis. Where the facts are harder, as in Example IV-1 below, a more fulsome factor-by-factor analysis will be appropriate.

Example IV-1: Partial Debt Contribution by Passive Minority Shareholder: Creditor-Capacity Characterization

Facts. Shareholder-Creditor is a pre-existing shareholder of D, holding 10% of D's outstanding stock. Shareholder-Creditor's stock ownership was acquired in a transaction wholly unrelated to, and well prior to, the transaction described in this example. Shareholder-Creditor holds no board seats and exercises no directional influence over D's management or restructuring plan; the remaining 90% of D's equity is held by a single concentrated shareholder that controls D's board and directs its operations. A third-party creditor holds $120 of senior debt of D. Shareholder-Creditor holds junior debt of D with an AIP of $120, a basis of $120, and an FMV of $80, reflecting the junior position behind the fully covered senior tranche in a distressed debtor. Immediately before the contribution, D has an enterprise value of $200 against total debt of $240. On a current liquidating-value basis, D's equity has no value, reflecting a liquidation deficit of $40 (enterprise value of $200 against total debt of $240); the equity retains nominal option value reflecting the possibility of a future recovery. D's management projections, prepared in the ordinary course and available to Shareholder-Creditor, reflect a base case in which the proceeds of the contribution (or savings from interest payments) are intended to fund modest repairs to deteriorating machinery, generating incremental operating cash flow sufficient to improve debt service coverage on D's remaining obligations — including Shareholder-Creditor's retained $60 junior position — but insufficient to produce a meaningful change in current or forward equity valuation. Shareholder-Creditor contributes $60 of the AIP of the debt (with $60 of allocable basis) to D for no consideration. Shareholder-Creditor retains the remaining $60 of AIP, which continues to be held as an outstanding junior obligation of D. D issues no stock to Shareholder-Creditor in connection with the contribution; Shareholder-Creditor's percentage interest in D is unchanged. The parties intend that the contribution be governed by Section 108(e)(6).

The retained $60 of AIP junior position has an FMV of $60 immediately after the contribution: the residual enterprise value remaining after the $120 senior tranche fully covers the retained $60 on a liquidating basis, so there is no further recovery prospect for FMV to capture

[44] Nevertheless, where value accruing outside the equity position is an incidental consequence of the contribution rather than a motivation for it — for example, where an improved creditor recovery flows naturally from a deleveraging that is primarily equity-motivated — that value does not necessarily undermine the shareholder-capacity conclusion.

beyond that coverage, and FMV and liquidating value coincide at $60; the pre-contribution pro-rata FMV of the portion that will be retained is $40 (i.e., $60/$120 × $80). The contribution accordingly produces two offsetting effects on Shareholder-Creditor's debt position: a decrease in the AIP of the position from $120 to $60, reflecting the elimination of the contributed portion, and an increase in the coverage of the retained position from 67% (FMV/AIP of $80/$120) to 100% (FMV/AIP of $60/$60), reflecting the deleveraging of D's capital structure. The net result across both components is an $18 economic loss on the contribution: Shareholder-Creditor surrenders $40 of pro-rata FMV on the contributed portion and receives back a $20 improvement in the FMV of its retained debt position (from $40 to $60) and $2 of current equity uplift (Shareholder-Creditor's 10% share of the increase in the liquidating value of D's equity from zero to $20, the equity value being floored at zero before the contribution notwithstanding the $40 liquidation deficit), leaving a net loss of $18. Stated differently, of the value arising from the contribution, roughly 91% accrues to Shareholder-Creditor's retained creditor position and only 9% to its equity.

Discussion. This Example raises the question whether Shareholder-Creditor is acting in the capacity of a shareholder or a creditor in making the partial contribution to D.

Applied to this Example, several factors weigh in favor of characterizing the contribution as a creditor-capacity act.

Under factor (a), Shareholder-Creditor contributes only half of its debt position ($60 of the $120 AIP), retaining the balance as an outstanding junior obligation. The partial nature of the contribution is not itself a negative inference of creditor capacity, but it is the combination of partial contribution with the other factors below, and in particular with the allocation of economic return addressed under factor (d), that supplies the creditor-capacity signal here.

Under factor (b), Shareholder-Creditor's 10% equity stake captures only $2 of current equity uplift against $40 of pro-rata FMV surrendered on the contributed portion. There is no requirement that equity uplift equal or exceed claim value surrendered, but where the current equity uplift is this small the shareholder-capacity explanation necessarily relies on the forward-looking analysis under factor (c), and the other factors carry correspondingly greater weight.[45]

Under factor (c), the available projections reflect a base case in which the contribution funds modest repairs to deteriorating machinery, generating incremental cash flow sufficient to improve debt service coverage on the retained $60 junior position but not sufficient to produce a meaningful change in equity valuation. The economic logic of the projections is the preservation of debt service coverage on the retained claim (i.e., creditor-capacity behavior) rather than the generation of equity value. The analysis would differ on facts supporting a credible expectation of catalytic forward equity value, for example where the contribution was expected to unlock a

[45] The contributor's return takes the form of a reconstituted continuing investment rather than a market-priced exchange, so exact FMV equivalence between what is surrendered and what is received is not expected; *Fink* confirms that a contributor may transfer more current value than it receives back and still make a qualifying contribution to capital.

refinancing or operational restructuring increasing D's enterprise value well beyond the static balance-sheet effect of the debt elimination.

Under factor (d), the contribution produces an $18 net economic loss for Shareholder-Creditor, and its creditor position declines as a whole from $80 of value to $60. As discussed under factor (d) above, that net give-up does not by itself resolve capacity: it can be read as pointing toward shareholder capacity, since a creditor acting solely to maximize recovery would not accept a net reduction in its position. What appears to resolve the question here is where the offsetting value accrues. Of the $22 in contribution-attributable value Shareholder-Creditor receives, roughly 91% ($20 of $22) accrues as improved FMV on its retained creditor position and only $2 as equity uplift, and the projections supply no basis for expecting forward-looking appreciation in the retained debt and equity beyond that reflected in current value. The value is therefore largely carried forward in the creditor component rather than reconstituted into equity, and the contribution functions more like a creditor's partial compromise. A contributor absorbing a current loss to relieve overleverage and protect the recovery on its retained debt is acting rationally in a creditor capacity, reflecting principal protection rather than the upside equity participation that characterizes shareholder-capacity contributions.

Under factor (e), Shareholder-Creditor holds no board seats and exercises no directional influence over D's management or restructuring plan, and its access to D's projections is no greater than that available to other creditors. Its position as a 10% passive minority holder is closer to the publicly traded passive-holder paradigm the 1980 Senate Report identifies as the archetypical creditor-capacity case than to the controlling shareholder directing a turnaround.

Under factor (f), the example does not posit any pro rata contribution by other shareholders in proportion to their equity holdings, nor any parallel concession by the third-party senior creditor situating the contribution within a broader equity-capacity restructuring. The senior creditor's position is left undisturbed and is materially benefited by the contribution. As to the probative factors noted in the introduction to factor (f), Shareholder-Creditor holds 100% of the junior debt (FMV $60 post-contribution) against only 10% of the equity (FMV $2), reflecting a capital structure in which the contributor's investment is overwhelmingly in creditor rather than equity form.

Under factor (g), the example does not posit any consideration flowing to Shareholder-Creditor outside its equity position.

On these facts, and assuming no other relevant factors, the better view is that the contribution is a creditor-capacity act, such that Section 108(e)(6) should be unavailable on that ground. The question is close, however, and a change in the factors could alter the characterization.

3. Shareholder requirement: pre-contribution

There is no statutory minimum holding period and no minimum quantum of equity ownership for pre-contribution equity. The operative question should be whether the contributor held equity at the moment of contribution and whether, taking into account the circumstances in

which Shareholder-Creditor acquired its equity, the debt contribution was made in a shareholder capacity under the dominant-motivation test discussed in Example IV-1.

Acquisition of equity pursuant to enforcement of a pledge of the equity granted as security for the debt may suggest that a debt contribution occurring shortly thereafter and as part of the same restructuring plan is made in a creditor-capacity. However, a contributor's equity may have originated from a prior and unrelated creditor-capacity transaction, whether through enforcement of a pledge of equity granted as security for the debt, a negotiated debt-for-equity exchange in an earlier workout, or another restructuring. Where the prior transaction is unconnected to the current workout (separated by time, arising under distinct economic circumstances, or otherwise unrelated), the shareholder-capacity inquiry is properly assessed at the time of the current contribution. Where equity was originally acquired in a creditor-capacity transaction, that historical circumstance may nonetheless be relevant to, though not necessarily determinative of, the capacity inquiry with respect to a subsequent contribution. A contribution following unanticipated deterioration in the debtor's financial condition after an initial restructuring is typically a response to post-initial restructuring circumstances rather than the execution of a pre-arranged plan, a consideration that may weigh against step-transaction integration.

A further fact pattern arises where the contributor's direct equity ownership is established through an upstream liquidation of an intermediate holding company occurring pursuant to a plan that includes the contribution. Where the liquidation is driven by non-tax considerations (including third-party financing arrangements, minority shareholder consent dynamics, or local regulatory regimes), that may weigh against integration. Even if the liquidation is intended to facilitate qualification under Section 108(e)(6), this ought to be permissible as a general matter because the creditor historically was an indirect shareholder and the liquidation merely converts indirect share ownership into direct share ownership. Other movements of debt or equity within a controlled group also may be consistent with a dominant shareholder capacity motivation. These determinations turn on the facts and circumstances of the particular transaction, and general tax principles, including the step-transaction doctrine, apply accordingly.

4. Shareholder requirement: post-contribution

Section 108(e)(6) imposes no statutory minimum holding period and no minimum quantum of equity ownership for post-contribution equity.

The continuing-investment premise of Section 108(e)(6) requires that value created by the contribution transmit through the contributor's equity position rather than accrue exclusively to its retained creditor position or other stakeholders, as discussed under the dominant-motivation test in Part IV.A.2. Post-contribution conduct and the quantum of equity held following the contribution should constitute relevant circumstantial evidence of the contributor's motivation at the time of contribution, subject to general tax principles including the step-transaction doctrine.

Two post-contribution scenarios warrant illustrative discussion. First, where the contributor's equity is sold to, or another disposition is made with, an unrelated third-party following the contribution, that should be viewed as consistent with a shareholder-capacity

contribution: the contributor held equity with value at the time of contribution, the contribution was made in shareholder capacity, and the arm's-length sale or other disposition is the mechanism by which the equity value is captured. A third-party purchaser will frequently demand a clean capital structure free of shareholder debt as a condition of the transaction, such that the debt contribution is itself reflected in the consideration the purchaser pays for the equity; the sale price reflects the post-contribution equity value, which is the economic return on the shareholder-capacity contribution. Accordingly, a contribution should not fail Section 108(e)(6) solely because one of its principal purposes is to facilitate an arm's-length sale or other disposition of the contributor's equity to or with an unrelated third-party following the contribution.

Second, where the contributor's equity is cancelled for no consideration following the contribution, the analysis turns on whether, under generally applicable step-transaction principles, the contribution and the subsequent cancellation are properly treated as integrated steps of a single plan, taking into account whether the cancellation was the consequence of intervening events occurring after the contribution rather than a pre-arranged step. Where step-transaction integration is established, the contribution and cancellation are treated as a single transaction; even if the equity had value at the moment of contribution viewed in isolation, the contributor is left with no continuing equity position through which to capture that value, and the reconstitution premise of the contribution-to-capital doctrine should not be treated as satisfied. For example, if pursuant to a Chapter 11 reorganization a shareholder contributes debt to the capital of a debtor corporation and pursuant to the reorganization the shareholder's equity is then cancelled for no consideration, that contribution should not qualify under Section 108(e)(6).

B. Gratuitousness and Equity Uplift

An element of the contribution-to-capital requirement is gratuitousness: the contribution cannot be made in exchange for bargained-for consideration. As discussed in Part III above, gratuitousness in the contribution-to-capital sense does not require donative intent. A contribution is gratuitous so long as the contributor receives no bargained-for consideration from the corporation or, in connection with the contribution, from another party operating as quid pro quo for the contribution. The contributor's pursuit of economic self-interest in the debtor's improved condition is consistent with gratuitousness; this element is a familiar feature of the Section 118 case law.

The gratuitousness element gives rise to a structural tension in applying Section 108(e)(6) and in the examples below. Section 108(e)(6) by its terms applies to a contribution made for no consideration, and in particular without the issuance of stock or other property in exchange for the contributed debt. At the same time, the capital contribution exception rests on the premise that the contributor is acting for the benefit of a continuing equity investment whose value may increase by reason of the contribution. Indeed, the contribution operates precisely by collapsing the debt component into the equity component of an ongoing investment, and the contributor can capture the uplift the contribution produces only through its pre-existing equity position. Equity uplift to the contributor is therefore consistent with — and indeed expected from — a Section 108(e)(6) contribution. The gratuitousness element does not require the absence of equity uplift; it requires

the absence of bargained-for consideration, which under *Fink* is the standard the generalized-benefit principle satisfies.

We recommend that, as a threshold matter, Treasury and the IRS confirm in guidance that the form of a capital contribution, or of an exchange of debt for the issuance of equity, generally should be respected. Accordingly, where no formal equity is in fact issued to the contributing shareholder, no formal equity should be deemed issued, and the transfer should be eligible for Section 108(e)(6). Where formal equity is in fact issued and the value of the equity issued equals the value of the debt exchanged therefor, the issuance should be respected and treated as within Section 108(e)(8). That treatment applies even where the contributor wholly owns the debtor.

Where a debt instrument is exchanged for consideration in form, but the value of the consideration received (even if in the form of stock) is less than the value of the debt exchanged, we recommend that, as a threshold matter, substance-over-form principles apply to characterize the transaction as a partial contribution and a partial exchange and the transaction as so characterized should then be analyzed as described in Part V. This treatment is consistent with the general application of substance-over-form doctrine to transactions between a shareholder and a corporation outside of the debt contribution area.[46] It also avoids distortions that would be created if form determined the amount of CODI recognized without regard to substance-over-form principles.[47]

Example IV-2: Shareholder-Creditor Wholly Owns the Debtor

Facts. Shareholder-Creditor owns 100% of the stock of D and $100 principal amount of D's debt with a basis equal to principal amount. D is distressed, as its assets have an FMV of only $40. Shareholder-Creditor contributes all of its D debt to capital, resulting in its existing stock of D being worth $40 after the debt contribution.

Discussion. The contribution to capital in this example should be respected as such for purposes of applying Section 108(e)(6) rather than Section 108(e)(8). A Shareholder-Creditor's contribution of debt without consideration is gratuitous in the contribution-to-capital sense not because the contributor lacks economic motive, but because the contribution operates as a further

[46] When a shareholder transfers property to a corporation and receives back consideration of lesser value, the difference is treated as a capital contribution by the shareholder. *See* Treas. Reg. § 1.61-12(a) ("if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt"); Treas. Reg. § 1.118-1; *Commissioner v. Fink*, 483 U.S. 89, 96-99 (1987) (controlling shareholder's voluntary surrender of stock to corporation, made to protect or increase value of remaining investment, is not an immediately deductible loss; basis reallocates to retained shares); *Frantz v. Commissioner*, 83 T.C. 162 (1984), *aff'd*, 784 F.2d 119 (2d Cir. 1986) (non-pro-rata surrender of preferred stock and gratuitous cancellation of shareholder advances treated as capital contributions); *cf. Sammons v. Commissioner*, 472 F.2d 449, 451-53 (5th Cir. 1973) (value shifts between a shareholder and his controlled corporations are characterized for tax purposes by reference to the shareholder's investment relationship).

[47] For example, CODI could be overstated if stock is issued with a value less than the debt and the value of the stock actually issued were used to determine the amount of CODI recognized under Section 108(e)(8). This distortion may be to the benefit or the detriment of the taxpayer or the government depending on the circumstance.

step in an ongoing equity investment rather than as a market-priced exchange.[48] It is true that the same economics could have been achieved in this example by cancelling the existing D shares and issuing new shares with an FMV of $40, thereby invoking the exchange mechanics of Section 108(e)(8), rather than the contribution mechanics of Section 108(e)(6). However, the Section 108(e)(8) exchange mechanics do not better explain the resulting position of the parties or how they got there. The choice between Section 108(e)(6) and Section 108(e)(8) treatment, where the structural prerequisites of Section 108(e)(6) are met in form and substance, is a legislatively sanctioned structuring choice between two acceptable alternatives, rather than an abuse to be policed by reference to FMV-equivalence between the two regimes.[49] Where no stock is in fact issued, the contribution should be governed by Section 108(e)(6), and absent additional facts sufficient to invoke the substance-over-form doctrine, substance should not be applied to deem a phantom issuance that did not occur.[50]

The harder cases arise where the contribution is accompanied by other transactions that may provide the contributor, or another shareholder, something more than a generalized equity uplift. The discussion below addresses two such circumstances: (i) contributions resulting in a disproportionate uplift to a non-contributing shareholder and (ii) contributions resulting in a

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[48] *See* Treas. Reg. § 1.61-12(a) (shareholder's gratuitous forgiveness of corporate debt treated as a contribution to capital to the extent of principal); Treas. Reg. § 1.118-1 (voluntary shareholder payments represent "an additional price paid for" the shares); *Commissioner v. Fink*, 483 U.S. 89 (1987) (shareholder's voluntary surrender of stock treated as a nontaxable contribution to capital, analogized to a Shareholder-Creditor's contribution of corporate debt).

[49] The longstanding administrative practice supports this principle. In a consistent series of private letter rulings, the IRS respected the form of the transaction and declined to treat a debt contribution as giving rise to consideration received by the contributing shareholder solely because no stock was issued, without inquiry into whether a stock issuance would have been economically inconsequential. *See* PLR 199923041 (Mar. 16, 1999); PLR 9623028 (Mar. 7, 1996); PLR 9404014 (Oct. 26, 1993); PLR 9335024 (June 3, 1993); PLR 9215043 (Jan. 14, 1992); PLR 9114020 (Jan. 4, 1991); PLR 9050031 (Sept. 17, 1990); PLR 9024056 (Mar. 20, 1990); PLR 8844032 (Aug. 8, 1988); PLR 8813041 (Dec. 31, 1987). PLR 200537026 (June 17, 2005) applied Section 108(e)(6) and Section 108(e)(8) respectively to two separate debt instruments held by two different creditors within the same restructuring, each governed by the form of that creditor's transaction, providing indirect support for the proposition that the form chosen for each component of a restructuring is respected independently. TAM 9830002 (Mar. 20, 1998) confirms the boundary: where the parties' chosen form included the issuance of stock to three affiliated creditors (the debtor's direct parent and two higher-tier entities, each in cancellation of a separate debt), the IRS respected that form and applied Section 108(e)(8), declining to disregard the issuance because it changed the legal relationships among the entities (i.e., the higher-tier affiliates became direct debtor shareholders for the first time, diluting the direct parent's interest from 100%). The TAM stands for the limited proposition that a stock issuance with independent legal significance will be respected; it does not address, let alone disturb, the administrative practice of declining to treat a debt contribution as giving rise to consideration where no stock was in fact issued. PLR 201016048 (Apr. 23, 2010) illustrates the converse: the IRS disregarded a transitory share issued solely for foreign tax reasons that had no legal or material economic consequences during the brief period it was outstanding and applied Section 108(e)(6), confirming that a share lacking legal or economic substance is not the kind of actual issuance that gives rise to consideration received by the contributing shareholder.

[50] This is the same boundary drawn in Part V.A, where the triggering fact for Section 108(e)(8) is the actual transfer of stock. The converse case, in which a wholly-owning shareholder does issue some stock in connection with a larger debt transfer, is addressed there.

percentage equity increase when taken together with another shareholder's concurrent exit (Example IV-3).

As to the first issue, we recommend that Treasury and the IRS clarify, consistent with *Fink*, that a non-pro rata capital contribution is not disqualified from Section 108(e)(6) because it incidentally benefits non-contributing shareholders, and that any recast under Revenue Ruling 73-233 operates at the shareholder level without disqualifying the transaction under Section 108(e)(6) at the corporate level.

As discussed in Part III.C, a non-pro rata contribution that produces a disproportionate equity-value increase to non-contributing shareholders should not render the contribution non-gratuitous so long as the benefit is generalized rather than specifically directed. Suppose A owns 20% of D's equity and B owns 80%; A holds $100 of D's debt (FMV $60) and B holds none. A contributes its debt to capital and receives no stock, and the resulting uplift in D's equity value accrues 20% to A and 80% to B, so that B, having contributed nothing, captures the larger share of the benefit. B should not be deemed to have received any D stock as a result of A's contribution, provided that B's increased equity value is a generalized consequence of the improvement in D's capital structure.

The result differs only where the value passing to B was specifically negotiated as the price of an action by B, as in Revenue Ruling 73-233 (a disproportionate benefit negotiated as quid pro quo for a particular action, recast as a first-step taxable transfer between shareholders). On such facts, consistent with that ruling, the recast should operate at the shareholder level (resetting the basis of the debt in the hands of the recipient shareholder to its FMV prior to the contribution, and thereby affecting the amount of CODI recognized by D), while the corporate-level treatment of the residual contribution remains governed by Section 108(e)(6). Indicia supporting recast include an agreement between the shareholders concerning the contribution, an agreement by the non-contributing shareholder to provide capital, services, releases, votes, or other consideration, arm's-length negotiation of the value shift, or integration with a broader restructuring under which the shareholders' relative positions are being adjusted by agreement; absent such indicia, *Fink* is the default and Section 108(e)(6) applies in full.

As to the second issue, we recommend that Treasury and the IRS provide guidance that concurrent corporate-level transactions affecting other parties' equity or debt do not, by themselves, disqualify a debt-to-capital contribution from Section 108(e)(6) treatment merely because they increase the contributor's stock ownership, subject to the dominant motivation test and general tax principles, including substance-over-form principles.

Example IV-3: Percentage Equity Increase from Concurrent Shareholder Exit

Facts. A and B each owns 50% of D's equity, and each holds $100 principal amount of D's debt with a basis equal to principal amount. D is distressed: D's assets have an FMV of $120 against $200 of principal debt, the debt is worth 60 cents on the dollar (FMV of $60 to each of A and B), and D's equity is worthless from a liquidation perspective.

In a single integrated restructuring undertaken pursuant to a plan, a third party C, unrelated to A, lends $80 to D on commercially reasonable terms. Of that funding, $60 is used to repay B in satisfaction of B's $100 face debt (a 60% recovery equal to the FMV of B's debt), and $20 is retained as working capital. B agrees for its equity to be concurrently repurchased for a nominal amount on the basis that its equity has zero or nominal value from a liquidation perspective, and B exits the investment. A retains its existing equity and contributes its $100 face debt to D as a contribution to capital for no consideration.

After the restructuring, A holds 100% of D's equity. D's assets are $140 ($120 of operating assets and $20 of working capital), D's debt is $80 (held by C), and D's equity has a liquidating value of $60. A's pre- and post-restructuring economic positions are equivalent measured on liquidating values: worthless 50% equity plus $100 face debt with an FMV of $60 before, and $60 of consolidated equity after.

Discussion. The Example presents one analytical question under the gratuitousness element: whether A's percentage equity ownership increase from 50% to 100% should be treated as a deemed issuance of formal equity by D to A in respect of A's debt contribution, which would render the contribution non-gratuitous and subject to Section 108(e)(8). *See also* Part V.E for further discussion on the interaction between Section 108(e)(6) and Section 108(e)(8). The Revenue Ruling 73-233 analysis discussed above is not applicable because B is an exiting shareholder receiving FMV consideration for its positions rather than a benefiting non-contributing shareholder.

A's percentage increase to 100% is a mathematical consequence of B's exit at FMV terms and the cancellation of B's worthless equity. No value is transferred to A from D, B, or any other party in respect of A's debt contribution. As the facts reflect, A's pre- and post-restructuring economic positions are equivalent on liquidating values. The benefit to A's continuing equity that follows from D's restored balance sheet is the generalized benefit *Fink* treats as compatible with capital-contribution treatment. No formal equity should be deemed issued to A by reason of A's percentage ownership increase, and A's contribution remains gratuitous in the contribution-to-capital sense. Section 108(e)(6) should apply.

The base facts of this Example are constructed so that A's equity uplift on liquidating values is equal to the FMV of the debt contributed: the new money introduced by C flows to repay B and to provide working capital, producing a 1:1 relationship between the debt eliminated and the value accruing to A's equity. In practice, however, the equity uplift to a contributing shareholder may exceed the FMV of the debt contributed, and this outcome is not anomalous but a natural consequence of how a contribution operates in a distressed capital structure.

Two mechanisms commonly drive this result. First, the FMV of contributed debt in a distressed company reflects the discount the market applies for credit risk and the prospect of impaired recovery — the FMV is depressed precisely because full repayment is uncertain. A contribution that eliminates that debt does not merely remove a liability equal to its FMV; it improves the company's overall credit profile, reduces the risk of default on remaining obligations, and reduces the discount the market applies to the company's enterprise value as a going concern.

Each of those effects produces value that flows through the contributor's continuing equity position, and their aggregate may exceed the FMV of the debt that was contributed. Second, a contribution that cures a covenant breach, restores compliance with a regulatory capital ratio, or unlocks access to additional third-party financing may produce a step-function increase in enterprise value that bears no proportional relationship to the FMV of the debt eliminated. The contribution operates as the trigger for a discrete value event — for example, releasing the company from default-driven restrictions on operations, refinancing, or distributions — and the value created by that event is realized through the contributor's equity position even though it is not measured by the FMV of the contributed debt.

In each of these cases, the contributor's equity uplift flows through its continuing equity position rather than through bargained-for consideration received outside that position, and the generalized-benefit principle of *Fink* is satisfied. An equity value increase captured through a continuing equity position — even one exceeding the FMV of the debt contributed — should not be treated as bargained-for consideration and should not defeat gratuitousness. Assuming that the dominant motivation test is satisfied[51], the fact that A's existing equity is the vehicle for the uplift, rather than the occasion for a deemed issuance of new stock, follows from A's shareholder capacity and the continuing-investment premise: where A acts in its capacity as a shareholder, the contribution is a further step in A's pre-existing and continuing equity investment, so the value reconstituted by the contribution is captured through the shares A already holds, and the statute does not require the issuance of new stock to give effect to it. A's increase in percentage ownership in the concurrent-exit case is the consequence of another shareholder's departure, not a transfer of stock to A. No formal equity should be deemed issued, and no separate consideration should be treated as received, by reason of an equity uplift of this kind. In these circumstances, transactions occurring at the corporation level — including a concurrent exit by another shareholder, a redemption or cancellation of another shareholder's equity, the introduction of new third-party financing, or an operational investment funded by that financing — generally should be respected as occurring at the corporation level and analyzed under their own governing tax principles, including the substance-over-form doctrine, rather than recast as a deemed issuance of formal equity to the contributing shareholder.

C. Threshold Conditions on the Contributed Debt

This section discusses various aspects of the contributed debt and its relationship to the continuing investment premise on which Section 108(e)(6) rests. The first, addressed in Part IV.C.1, is whether the contributed instrument is debt with value: a contribution of a worthless instrument reconstitutes nothing, and basis migration under Section 1016(a)(1) is correspondingly zero. The second, addressed in Part IV.C.2 through Examples IV-4 and IV-5, is whether the debtor's equity has sufficient value — taking into account the effect of the contribution itself in

[51] For example, the disparity in the treatment of A's stock and B's stock may be the product of A and B having different perspectives regarding their existing equity, with A being committed to rehabilitation and continued investment and B simply wanting to terminate its investment and cut its losses. In such circumstances, the dominant motivation for A's continued ownership of its existing equity is consistent with its acting in a shareholder capacity and not a mere artifice to avoid the application of Section 108(e)(8).

relieving the insolvency or distress that the contributed debt reflects — to support the premise that the contribution is the reconstitution of a continuing investment in a viable enterprise rather than the wind-down of a position whose going-concern character has been extinguished. The third, addressed in Part IV.C.3, is whether the contributor acquired the contributed instrument in a manner consistent with the capacity determination of Part IV.A, ensuring that the contribution-to-capital form is not used to shelter what is in substance a creditor's acquisition and immediate compromise of a distressed claim.

1. Value of the contributed debt: the Shareholder-Creditor side

An implicit threshold condition on the application of Section 108(e)(6) is that the instrument the shareholder transfers to the corporation be debt with at least potential value (which can be derivative of its ability to delay or "hold up" the implementation of a restructuring transaction). The IRS has taken the consistent administrative position that a worthless debt cannot constitute a gratuitous contribution and therefore cannot qualify as a contribution to capital — there is nothing of value to contribute.[52]

The substantive worthlessness standard derives from *Morton*, a stock-worthlessness case whose analysis the courts and commentators have applied, with appropriate modifications for debt's priority position, to the worthlessness of debt instruments under both Section 165(g) and Section 166.[53] Under *Morton*, an instrument should be treated as not worthless so long as it has current liquidating value or "potential value" — a reasonable hope and expectation of future value from the foreseeable operations of the issuer. A bankruptcy filing or balance-sheet insolvency does not establish worthlessness under this standard if either form of value remains. The *Morton* standard is accordingly more demanding than balance-sheet insolvency. An identifiable event — such as bankruptcy adjudication, dissolution, or cessation of business — is relevant under *Morton* as evidence that potential value has been extinguished but is neither a necessary nor a sufficient condition for worthlessness; the inquiry remains one of facts and circumstances in all cases. Whether Section 165(g) or Section 166 applies depends on whether the contributed debt is a security within the meaning of Section 165(g)(2)(C), as established in Part III.G.1 above; that determination affects the character of any loss at the shareholder level but does not alter this substantive worthlessness inquiry.

We believe *Morton's* "potential value" prong should be understood to encompass holdup value — the value a Shareholder-Creditor may realize by reason of its ability to block or condition a restructuring, even where the claim is out of the money on a current liquidating value basis. That value is a form of forward-looking value arising from the foreseeable resolution of the issuer's financial situation and fits within the spirit of *Morton's* open-ended "reasonable hope and

[52] PLR 200537026 (including a taxpayer representation that the contributed debt had positive FMV at the time of the debt contribution). Even if the cancellation were respected as a qualifying contribution to capital for Section 108(e)(6) purposes, CODI would result. Under Section 108(e)(6)(B), the corporation is deemed to satisfy the contributed debt with cash equal to the contributing shareholder's adjusted basis. Where the contributed debt is wholly worthless, the shareholder's adjusted basis is zero, the deemed satisfaction is correspondingly zero, and CODI equals the full AIP.

[53] *Morton v. Commissioner*, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940).

expectation" formulation. The contributed debt should accordingly not be treated as worthless where holdup value of this kind exists.

We recommend that Treasury and the IRS make clear in guidance that Section 108(e)(6) requires the contributed debt to have value — whether current liquidating value or "potential value" within the meaning of *Morton* (which can be derivative of its ability to delay or "hold up" the implementation of a restructuring transaction) — at the time of contribution, and provide guidance adopting the worthlessness standard of *Morton* as implemented through Sections 165(g) and 166 as the applicable standard for this condition.

We believe that a bankruptcy filing or balance-sheet insolvency should not establish worthlessness for this purpose if any of these forms of value remains. The relationship between this value condition and the separate transferee-side question of balance-sheet insolvency is discussed in Part IV.C.2 below.

2. Solvency of the debtor: the transferee side

A separate threshold question, addressed at the transferee side, is whether the debtor's pre- or post-contribution solvency operates as an independent requirement under Section 108(e)(6). In FSA 199915005, the IRS took the position that Section 108(e)(6) does not apply to the extent the debtor is insolvent before the contribution, with the consequence that the portion of the contribution corresponding to that pre-contribution insolvency would generate CODI subject to the insolvency exception under Section 108(a)(1)(B) and the attribute-reduction discipline of Section 108(b).[54] Such a bifurcation is inconsistent with the continuing investment premise of the capital contribution exception. The exception applies in full or not at all, subject only to the use of basis in the CODI calculation. The two Examples below develop the analysis: Example IV-4 addresses pre-contribution insolvency where the debtor is solvent after the contribution, and Example IV-5 addresses pre- and post-contribution insolvency.

[54] FSA 199915005 (Dec. 17, 1998). The FSA applied the insolvency exclusion of Section 108(a)(1)(B) to the portion of a shareholder's debt contribution that it determined did not qualify as a capital contribution under Section 108(e)(6), on the ground that the contribution did not render the debtor solvent. This approach is in tension with PLR 8844032 (Aug. 8, 1988), in which the IRS applied Section 108(e)(6) to the full amount of a debt cancellation by a shareholder to an insolvent corporation without division, and with PLR 202112003 (Dec. 29, 2020), which applied Section 108(e)(6) to a full foreign-parent forgiveness of an insolvent subsidiary's debt. *Cf.* FSA 200146013 (June 27, 2001) (debt-for-debt exchange between parent and subsidiary). The FSA's treatment of the Section 108(e)(10)/Section 108(e)(6) interaction is addressed more fully in Part V.B below. The FSA's footnote 6 sets out the IRS's stated rationale. Commentators have provided alternative viewpoints or highlighted differing caselaw regarding the FSA's position. *See* Henderson & Goldring, Tax Planning for Troubled Corporations Section 505 (2025 ed.); Garlock, Federal Income Taxation of Debt Instruments Section 1502.04[B]; Potter & Harris, Unintended Tax Consequences From Intercompany Debt Cancellations, 37 J. Corp. Tax'n No. 5, at 3 (Sept./Oct. 2010); Levine & Molins, Partial Debt Cancellations: Slicing Debt with Occam's Razor, 129 Tax Notes 311 (Oct. 18, 2010).

Example IV-4: Insolvent Before, Solvent After

Facts. Prior to contribution: Asset Value = $100; Liabilities = $300; Equity Value = −$200. Shareholder-Creditor contributes all $300 of its debt to capital for no consideration. After the contribution, the Asset Value is $100; Liabilities = $0; Equity Value = $100.

Discussion. The pre-statutory case law (*Lidgerwood* and *Krueger*) established that a shareholder's cancellation of corporate debt, where the cancellation has the character of a contribution to capital, does not produce CODI to the debtor.[55] *See* Sections III.C and III.F above. *Lidgerwood* itself involved a debtor that was insolvent both before and assumed to be after the cancellation. Section 108(e)(6) codifies that result and overlays a single statutory cutback: the corporation recognizes CODI to the extent the shareholder's basis in the contributed debt is less than the AIP, addressing the *Putoma* asymmetry between deduction and inclusion. That cutback is calibrated to the tax-history mismatch the 1980 Senate Report identified as the legislative concern; it does not impose a solvency condition on the contribution-to-capital characterization itself.

The FSA position departs from this baseline. In FSA 199915005, the IRS took the position that Section 108(e)(6) does not apply to the extent the debtor is insolvent before the contribution; on the facts of this Example, the FSA approach would treat $200 of the $300 contribution as producing CODI — the excess of liabilities over asset value before the contribution — and only $100 as qualifying for Section 108(e)(6) treatment. The IRS's stated rationale, set out in the FSA's footnote 6, is that the amount of cancelled debt resulting in CODI should equal the debt the debtor cannot pay off with its assets. Under the FSA approach, the resulting CODI would be excludable under Section 108(a)(1)(B) to the extent of the debtor's pre-contribution insolvency, with corresponding attribute reduction under Section 108(b). Section 108(e)(6)(B) identifies the shareholder's adjusted basis — not the FMV of the debtor's assets — as the sole measure of the deemed satisfaction amount and contains no solvency threshold. The FSA approach should be understood as substituting a balance-sheet metric for the one the statute prescribes, and does so at the measurement stage rather than the exclusion stage: insolvency is, under the structure of Section 108, an exclusion-stage variable addressed by Section 108(a)(1)(B) and the attribute-reduction discipline of Section 108(b), not a variable that operates to limit the scope of Section 108(e)(6) in the first instance. PLR 202112003 (Dec. 29, 2020) applied Section 108(e)(6) to a partial foreign-parent debt forgiveness without a pre-contribution solvency threshold, and Treas. Reg. § 1.61-12(a) provides that a shareholder's gratuitous forgiveness of corporate debt constitutes a

[55] *Lidgerwood Manufacturing Co. v. Commissioner*, 22 T.C. 1152 (1954), *aff'd*, 229 F.2d 241 (2d Cir. 1956) (parent's cancellation of subsidiary debt held a capital contribution even though the subsidiaries were insolvent both before and, as assumed, after; eliminating the debt was a valuable contribution to the financial structure of the subsidiaries). In *Lidgerwood*, the parent contributed only part of the total debt owed, cancelling $300,000 of a $411,000 obligation, and the court nonetheless respected the partial contribution. W.A. *Krueger Co. v. Commissioner*, 26 T.C.M. (CCH) 946, T.C. Memo. 1967-192 (same conclusion where debtor was insolvent both when funds were advanced and when debt was cancelled; creditor "could reasonably expect payment only out of [the debtor's] possible future earnings and profits"; debtor's operations served a business purpose for the creditor; creditor intended to strengthen the subsidiary "thereby increasing the possibility of dividends from future prosperity"; cited *Lidgerwood* approvingly and rejected *Giblin* on the facts).

contribution to capital to the extent of the principal of the debt, without conditioning the result on solvency.

The principal policy argument for a solvency threshold is that, to the extent a debtor cannot pay its obligations from existing assets, the contributing shareholder is resolving a position already economically extinguished rather than reconstituting a continuing investment, and permitting full Section 108(e)(6) treatment shelters CODI that would arise on a third-party discharge. We do not find this persuasive. Section 108(e)(6) is premised on the contributing shareholder's investment value being reconstituted and carried forward into equity rather than permanently extinguished, and that premise does not fail merely because the debtor is balance-sheet insolvent: reduced liquidation value may be temporary, the debtor's equity may carry real forward option value expected to increase upon restructuring or operational improvement as discussed in Part IV.A.2, and a contributor acting in shareholder capacity may rationally give up current claim value in exchange for equity value the contribution is expected to produce — precisely the assessment *Fink* upheld as a nontaxable contribution to capital even where the surrendering shareholders transferred more current value than they received back as immediate equity uplift. Extracting CODI on the insolvent portion is therefore in direct tension with the continuing-investment premise that Section 108(e)(6) is built on, which presupposes the contributed debt carries value being reconstituted into equity, not permanently surrendered as a taxable event.

The FSA approach also distorts the anti-*Putoma* symmetry that Section 108(e)(6) was enacted to preserve: it can produce CODI even where the shareholder's basis fully equals the AIP — exactly the case in which the *Putoma* asymmetry is absent. Moreover, Section 118 would continue to apply to a cash contribution to capital without regard to solvency, and a contribution of debt is economically equivalent.

Example IV-5: Insolvent Before, Insolvent After

Facts. Prior to contribution: Asset Value = $100; Liabilities = $300; Equity Value = −$200. D continues to operate as a going concern with a reasonable prospect of continued operations; its assets include operating assets whose going-concern value exceeds their liquidation value. D has developed, but not yet implemented, a restructuring plan that includes additional liability reductions and operational initiatives expected to grow asset value; D's management projections prepared in the ordinary course in connection with that plan reflect a credible expectation of future earnings and a path to positive equity value upon implementation. The contribution by Shareholder-Creditor is one step in that broader restructuring, undertaken to improve D's capital structure and enable the remaining steps to proceed. Shareholder-Creditor contributes $120 of its debt to capital for no consideration. A third party holds $180 of the debt.

After contribution: Asset Value = $100; Liabilities = $180; Equity Value = −$80. D continues to operate as a going concern after the contribution, with the remaining restructuring steps not yet implemented and the equity value not yet reflecting the expected value of the plan.

Discussion. This Example presents the same question raised in Example IV-4, with the additional feature that the debtor remains insolvent after the contribution. On these facts the FSA

position is even more untenable: because pre-contribution liabilities of $300 exceed assets of $100 by $200 — an amount greater than the $120 contributed — the FSA automatically would deny Section 108(e)(6) treatment to the entire $120 contribution and treat the full amount as CODI, a result that has no basis in the statutory text for the reasons discussed in Example IV-4. The precise question (i.e., whether contribution-to-capital treatment is available where the debtor remains insolvent after the cancellation) was presented and squarely resolved in favor of the contributor in both *Lidgerwood* and *Krueger* as discussed in Example IV-4. *Mayo* is sometimes cited for the contrary proposition, but the case is distinguishable; it turned on three compounding circumstances absent here: continued post-cancellation insolvency with no going-concern value, no enhancement of the value of the shareholder's stock, and a sale rather than continued-operation motivation. The case should not be viewed as authority for a categorical post-contribution solvency requirement.[56]

The post-contribution solvency question engages the continuing-investment premise of Section 108(e)(6) more directly than the pre-contribution question, because it asks whether, after the contribution, the debtor's equity retains sufficient forward-looking value to support the reconstitution thesis — that the contributor has collapsed its debt component into a surviving equity component worth holding as a continuing investment. The stipulated facts illustrate precisely why balance-sheet insolvency at the moment of contribution is a poor proxy for the absence of that value: D's post-contribution balance-sheet reflects a snapshot that does not yet incorporate the value expected to be generated by the remaining steps of the restructuring plan. The equity component is under water on a liquidation basis, but it carries real forward-looking value grounded in a concrete plan with documented projections. That is precisely the kind of value that factor (c) of Example IV-1 identifies as a credible basis for shareholder-capacity treatment, and that the *Morton* standard protects when it declines to treat balance-sheet insolvency as establishing worthlessness.

The shareholder-capacity inquiry as to dominant-motivation points in the same direction and, in our view, already incorporates the continuing-investment premise that a separate post-contribution solvency test would be intended to provide. Under factors (b) and (c) of Part IV.A.2, where the contributor's share of current equity uplift is small relative to the claim value surrendered — as it necessarily is where the equity is negative on a liquidation basis after the contribution — the capacity analysis relies heavily on the credibility of the forward-looking equity-value explanation, which on the stipulated facts is documentable: D has a concrete restructuring plan with management projections prepared in the ordinary course reflecting a path to positive equity value, and the contribution is one step in implementing that plan. Under factor (d), where the contribution is made in genuine shareholder capacity, a meaningful share of the value arising from the contribution should flow in equity form — through improved current or forward equity value — rather than accruing entirely to the contributor's retained creditor position. Under factor

[56] *Mayo v. Commissioner*, T.C. Memo. 1957-9. *Mayo*'s "hopelessly insolvent" formulation is properly read as an application of the identifiable-event exception articulated in *Morton v. Commissioner*, 38 B.T.A. at 1278-79, for debtors that have no chance of future turnaround, and not as authority for a freestanding balance-sheet solvency threshold. The IRS has taken the same view in pre-Section 108(e)(6) administrative guidance: "where the debt is worthless, it cannot be deemed to constitute a gratuitous cancellation . . . [c]onsequently there is nothing to forgive." PLR 5411085730A (Nov. 8, 1954); *accord* TAM 200101001 (Aug. 7, 2000).

(e), Shareholder-Creditor's participation in directing the restructuring gives it both the information and the agency to assess whether the contribution will unlock the enterprise value the plan projects. Where the capacity inquiry is satisfied on these grounds, the contribution is by definition one made for the benefit of a continuing equity investment in a viable enterprise, making any independent transferee-side solvency condition unnecessary.

We recommend that Treasury and the IRS provide guidance that no balance-sheet (or similar) solvency threshold, whether measured before or after the contribution, applies as an independent limitation on Section 108(e)(6), and that the approach in FSA 199915005 not be adopted. The dominant motivation test alone is sufficient to enforce the policies of Section 108(e)(6), without a bright-line requirement of post-contribution solvency or minimum equity value on a fair market value basis.

To the extent Treasury and the IRS determine that an explicit, additional transferee-side requirement of post-contribution equity value is appropriate (recognizing that, as a threshold matter under Parts IV.A.2, Section 108(e)(6) should be, in any event, unavailable where the contributor's equity carries neither current liquidating value nor potential value after the contribution), they should consider adopting a requirement providing only that the contribution create or increase either current liquidating value or "potential value" of the corporation's equity on a fair market value basis, rather than a balance-sheet solvency threshold. Such a requirement could be informed by the *Morton* "reasonable hope and expectation" of future value from foreseeable operations and "potential value" formulation and the *Lidgerwood* and *Krueger* case-law baseline, which also governs the creditor-side value condition of Part IV.C.1, adapted to the transferee-side perspective. The factors comprising such a test substantially overlap with the dominant-motivation factors, particularly factors (b), (c), and (d); where the capacity inquiry is satisfied, the test should in most cases also be satisfied.

3. Manner of acquiring the contributed debt

The "from a shareholder" requirement is a status determination addressed at the moment of contribution. A separate but related question is whether the manner in which the contributor acquired the contributed debt bears on the analysis — in particular where the debt is acquired shortly before the contribution or moved through intermediate steps as part of a restructuring plan that culminates in the contribution.

There is no statutory requirement that the contributor's holding of the contributed debt predate the contribution by any minimum period. The operative constraint is not temporal but motivational: where the acquisition of the debt and the subsequent contribution are undertaken pursuant to a single integrated plan, the dominant-motivation inquiry applies to the full sequence, and the step-transaction doctrine governs whether the acquisition and contribution should be analyzed as a single transaction.

Where the contributor acquires debt from an unrelated holder in the secondary market, Section 108(e)(4) and Treas. Reg. § 1.108-2 may apply depending, among other requirements, on whether the contributor bears a Section 267(b) or 707(b)(1) relationship to the debtor at the time

of acquisition. Where Section 108(e)(4) applies, the deemed-issuance mechanic of Treas. Reg. § 1.108-2(g) resets the AIP to the acquisition cost, and Section 108(e)(6) then operates on that reset instrument on the subsequent contribution — the two provisions work in sequence with no independent Section 108(e)(6) overlay at the acquisition stage.[57] Where Section 108(e)(4) does not apply and the contribution occurs immediately after the acquisition in an arm's length transaction that is respected as independent, the shareholder's basis in the debt will reflect its fair market value at the time of acquisition. Under one view, Section 108(e)(4) fills the field for related-party acquisitions in this manner, and the absence of Section 108(e)(4) should therefore weigh in favor of Section 108(e)(6) applying to the subsequent contribution. The full interaction between Section 108(e)(4), the step-transaction doctrine, and the capacity inquiry of Part IV.A in debt acquisition contexts raises complexities beyond the scope of this Report.

V. INTERACTION AMONG SECTIONS 108(E)(6), 108(E)(8), AND 108(E)(10)

Having addressed the threshold requirements for a qualifying contribution to capital in Part IV, and having discussed the role of form and substance in determining whether Section 108(e)(6) applies versus Sections 108(e)(8) or 108(e)(10), we turn to the question of whether a single instrument can be separated into a portion governed by Section 108(e)(6) and a portion governed by Section 108(e)(8) or Section 108(e)(10).

The three provisions contain materially different measurement rules. Section 108(e)(6) measures the deemed satisfaction by reference to the contributing shareholder's adjusted basis in the contributed debt, preserving the shareholder's unrecovered tax cost across investments in the same issuer rather than measuring a market-priced disposition. Section 108(e)(8) measures the deemed satisfaction of debt exchanged for stock by reference to the FMV of the stock transferred, an FMV-based rule that reflects the character of an exchange transaction in which the creditor is receiving consideration of ascertainable market value. Section 108(e)(10) measures the actual or deemed satisfaction by reference to the issue price of the new instrument, which for publicly traded debt equals its FMV.

This Part of the Report will discuss (i) whether a transaction involving a single debt instrument can be divided into a Section 108(e)(6) component and/or a Section 108(e)(8)/(e)(10) component, (ii) assuming division is permitted, how the portion of the transaction governed by each section is to be determined, and (iii) how the significant modification / deemed exchange rules of Treas. Reg. § 1.1001-3 are to be applied when there is a partial contribution of a debt instrument under Section 108(e)(6) and a portion of the debt is retained. As a preliminary matter, however, this Part first considers the role of form versus substance and the potential application of certain aggregation principles.

A. Form, Substance, and Aggregation

As an initial matter, we begin by reiterating, for clarity, our recommendations in Part IV.B regarding form versus substance. That is, the boundary between Section 108(e)(6) and Section

[57] Treas. Reg. § 1.108-2(g)(4), Example 3.

108(e)(8) generally should be determined by the form of the transaction (i.e., whether stock is actually issued or not). However, if the purported exchange is not value-for-value (e.g., the value of the stock issued is less than the value of the debt cancelled), substance-over-form principles should apply to characterize the transaction as a partial contribution and a partial exchange and the transaction as so characterized should then be analyzed as described below.

A related issue concerns the treatment of separately held units of a single "issue." Under Treas. Reg. § 1.1275-1(f), two or more debt instruments are part of the same issue where they have the same credit and payment terms and are issued pursuant to a common plan or as part of a single transaction or a series of related transactions, within the applicable time period. Ordinarily, units of a single issue share a uniform AIP and, assuming the units are fungible, the same per-unit fair market value, but the holder's basis is determined at the holder level and can differ across units depending on the lot in which they were acquired. For example, assume that a Shareholder-Creditor owns two debt instruments of the same issue that were acquired at different times and have different bases: one a low basis block and another a high basis block. If the Shareholder-Creditor contributes the high basis debt to capital (thereby minimizing CODI) and retains the low basis instrument or exchanges it for stock or new debt of the issuer, should the transactional form be respected as to the treatment of the two blocks, or should the two blocks be aggregated and, regardless of form, the transaction be recast as a part contribution of an aggregated single instrument and part retention or exchange of the remainder of the single instrument?

Here, references to different authorities support differing conclusions. On the one hand, under general tax principles, the unit of property is the individual debt instrument. Each unit of a debt issue is ordinarily a separate and distinct property right of the holder: individual units may be acquired at different times and prices, may sit in different cost lots, may be separately transferred, and carry their own holding periods, and they are not automatically combined into a single property right.[58] For example, the Shareholder-Creditor generally can choose to dispose of one instrument and retain the other, or to sell each instrument for different consideration (at least where there are two separate buyers even if related to each other and potentially even where there is a single buyer). In general, this choice is respected in accordance with the transactional form, as evidenced by the seller's ability to designate which bond is transferred under Treas. Reg. § 1.1012-1(c)(6).[59] Similarly, the case for respecting form in this context is supported by the ability of taxpayers to

[58] The tax treatment of debt generally treats legally distinct entitlements as distinct property even where they are economically equivalent. *See Cottage Savings Association v. Commissioner*, 499 U.S. 554, 566 (1991) (an exchange of economically equivalent mortgage participation interests was a realization event because the interests "embodied legally distinct entitlements"). The separately transferable character of individual units is the feature that distinguishes them from a single, stapled instrument: separately tradable components are generally treated as distinct instruments, whereas components that cannot be separately transferred are treated as a single instrument. *See* Rev. Rul. 2003-97, 2003-2 C.B. 380 (treating a note and a purchase contract issued as a unit as separate instruments where the holder had an unrestricted legal right to separate and transfer the note and was not economically compelled to keep the unit together, and citing other authorities on the separable-versus-stapled distinction).

[59] The same intuition appears in an ordinary issuer self-tender: where an issuer repurchases a portion of an issue and leaves the balance outstanding on unchanged terms, the untendered instruments are generally viewed as not integrated with the repurchased ones and tested as a single partially-modified instrument. The result thus turns on whether the issue is treated as a single integrated instrument or as separately transferable instruments.

designate pursuant to the terms of exchange which securities are exchanged for qualifying or non-qualifying consideration in a reorganization exchange under Treas. Reg. § 1.358-2(a)(2)(ii), provided that such allocation is economically reasonable (which generally requires that all exchanges be value-for-value under the designated allocation).

On the other hand, at least in certain circumstances, taxpayers are not able to allocate freely consideration received in exchange for property transferred. The leading example of this limitation is Rev. Rul. 68-55, which provides that transferee stock and other property received from the transferee in a Section 351 exchange must be ratably allocated among the properties exchanged by the transferor in applying Section 351(b), thereby precluding "cherry-picking" in such context.[60] Additional support for this approach may be viewed as inherent in Treas. Reg. § 1.1275-2(c), which, for purposes of determining the issue price of debt instruments and thus original issue discount, aggregates multiple instruments issued in the same transaction into a single instrument addressing the potential for taxpayer manipulation through fragmentation.[61]

At least three standards are possible. First, a Shareholder-Creditor could be permitted to treat different blocks of debt instruments differently (so long as the different treatment is economically reasonable) and, as a result, the analysis below regarding the potential division of a single instrument would be inapplicable to a transaction involving, in form, disparate treatment of two historically separate instruments. Second, all debt instruments of the same issue, even if acquired separately by the Shareholder-Creditor, could be aggregated and thus treated as a single instrument for purposes of the analysis below. Third, the general rule could be separate treatment, with aggregation/single instrument treatment applying only where at least one component of the transaction qualifies as a Section 351 exchange.

We believe that Treasury and the IRS should provide guidance addressing these issues, although we do not express a definitive view as to the proper standard at this time. The remainder of the Report considers issues associated with dividing a single instrument into a Section 108(e)(6) component and a component under Section 108(e)(8) or (e)(10) (and does not consider issues associated with disparate treatment of more than one instrument of a single issue).

B. Divisibility

We believe that taxpayers should be able to divide a single instrument and treat one portion of a transaction as subject to Section 108(e)(6) and the other as subject to Sections 108(e)(8) and/or 108(e)(10), an approach which we refer to as the "Divisibility Approach." We do so for several reasons.

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[60] 1968-1 C.B. 140.

[61] Treas. Reg. § 1.1275-2(c)(1). The aggregation rule applies to debt instruments issued in connection with the same transaction or related transactions and ordinarily applies only to debt instruments of a single issuer issued to a single holder. By its terms, the rule applies for purposes of Sections 1271 through 1275 and the Treasury regulations thereunder.

First, divisibility is supported by analogy to Treas. Reg. § 1.1275-2(f), which treats a pro rata prepayment as a retirement of a corresponding portion of the instrument.[62] The contribution of a portion of an instrument is analogous to the pro rata prepayment addressed in Treas. Reg. § 1.1275-2(f), which treats such a prepayment as a retirement of a corresponding portion of the instrument while the remainder continues outstanding on its original terms.

Second, if debt instruments were not divisible, then a partial contribution would be treated as a significant modification of the entire instrument under Treas. Reg. § 1.1001-3(g) Example 3, the contributor would recognize CODI measured by the AIP of the whole instrument less the issue price of the deemed new instrument. As the contributed portion approaches the whole, that CODI approaches the result for a complete cancellation, even though a contribution of the entire instrument would be governed by Section 108(e)(6), not by the significant-modification rules, and produces no CODI on these facts, as illustrated in Example V-3. A rule under which a near-complete contribution produces near-maximal CODI but a complete contribution produces none lacks a discernible policy basis. Further, and relatedly, because the threshold for a significant modification on change-in-yield grounds is modest, a partial principal reduction of more than minimal size will almost always exceed it. If Treas. Reg. § 1.1001-3(g) Example 3 governed every partial contribution on that basis, Section 108(e)(10) would displace Section 108(e)(6) in the ordinary run of partial-contribution cases, leaving Section 108(e)(6) with little practical application outside the contribution of an entire instrument.[63]

On the other hand, we acknowledge that it can be argued under a non-divisibility theory (the "Non-Divisibility Approach") that Section 108(e)(6) governs a defined transactional form - a contribution of debt to capital for no consideration - and once a restructuring includes consideration flowing to the contributor in the same transaction, the entire transaction is governed by Section 108(e)(8) or Section 108(e)(10). The textual grounding is the statutory condition that the corporation acquire its indebtedness "as a contribution to capital": a transaction that includes consideration flowing back to the contributor is not a contribution to capital as a textual matter, and treating part of such a transaction as a contribution strains the statutory language. Step-transaction principles determine whether a contribution element and a separate exchange are parts of the same transaction. As previously discussed, we believe that this approach is inconsistent with the reality that taxpayers can independently transfer portions of a debt position, would virtually

[62] Treas. Reg. § 1.1275-2(f)(1)-(2), promulgated in T.D. 8517, 59 Fed. Reg. 4799 (Feb. 2, 1994). A pro rata prepayment is an unscheduled payment that results in a substantially pro rata reduction of each remaining payment on the instrument.

[63] If it is determined, as discussed above, that a Shareholder-Creditor can transact with the issuer differently with respect to separate debt instruments of the same issue, then the case for divisibility of a single instrument becomes even stronger. Otherwise, formal differences not grounded in economic differences would drive disparities in tax treatment that would seem to serve no tax policy objective. A third-party analogue illustrates the form-sensitivity. Assume a publicly traded distressed debt issue, trading below par, that the parties wish to reduce by 30 percent. If each instrument is reduced ratably, every instrument is significantly modified on change-in-yield grounds under Treas. Reg. § 1.1001-3(e)(2) and deemed exchanged, generating CODI measured by the difference between the old AIP and the issue price of the reduced debt. If instead 30 percent of the individual instruments are cancelled in full and the remainder continue unchanged, only the cancelled principal produces CODI, and the surviving instruments generate none because they are not modified.

displace Section 108(e)(6) in most partial contribution cases, and can create CODI results that are difficult to justify when compared with the results of a complete contribution.

On balance, we recommend that Treasury and the IRS provide guidance adopting the Divisibility Approach, so that a single debt instrument can be divided, such that only a portion can be contributed by a shareholder to the capital of the corporation in a transaction governed by Section 108(e)(6), and the remaining portion can be held by the shareholder or exchanged in a transaction governed by Sections 108(e)(8) or (e)(10).

C. Allocation Between the Divided Portions

The remainder of the discussion in this Report assumes that the Divisibility Approach is adopted. On that assumption, we believe that each component of a transaction should be characterized by the provision whose statutory trigger it satisfies, determined based on both the form and substance of what occurred: the gratuitous-contribution trigger of Section 108(e)(6), the stock-transfer trigger of Section 108(e)(8), or the deemed-exchange trigger of Section 108(e)(10) arising from a significant modification.

For a Section 108(e)(6)/Section 108(e)(8) overlap, the exchange component should be sized by reference to the fair market value of the stock received, determined at the time of the exchange and thus after any deleveraging produced by the transaction, as compared with the fair market value of the debt exchanged. The contribution component would constitute the remainder of the debt instrument.

Once the portion governed by Section 108(e)(6), on the one hand, and Section 108(e)(8), on the other hand, are determined, a portion of the instrument's AIP and basis must be allocated to each, and CODI computed under each component's governing provision. In the T.D. 8517 preamble for the pro-rata prepayment rules of Treas. Reg. § 1.1275-2(f), Treasury expressed concern that a non-pro-rata prepayment with a rate or schedule alteration risked "inappropriate recognition of gain or loss" through distortion of the allocation of the instrument's tax history between the retired and surviving strips. The extent to which this concern carries over to the Divisibility Approach depends on whether the allocation of AIP and basis between the contributed portion and the exchange portion could be distorted. A "Ratable Allocation" approach would address this concern. Under a Ratable Allocation approach, AIP and basis would be allocated between the exchange component and the contribution component consistent with how each component was sized (i.e., in this context, based on relative fair market values with each component being treated as having the same value on a proportionate basis). Accordingly, we recommend that Treasury and the IRS provide guidance that, where a single debt instrument is divided and only a portion is contributed to capital, the instrument's basis and AIP be allocated ratably between the contributed and retained portions.

For a Section 108(e)(6)/Section 108(e)(10) overlap, the sizing of the two components depends on whether the retained portion is itself significantly modified. Where the retained portion is not significantly modified, the form of the transaction should govern the sizing of the components. That is, the size of the Section 108(e)(6) component should align with the proportion

of the debt instrument that is in fact contributed to capital and the size of the retained portion should align with the proportion of the debt instrument that remains outstanding. Under the Ratable Allocation approach, which we recommend, AIP and basis would be allocated ratably between the two components in the same proportion as determined by the sizing of the components. As described below in Part V.D., we believe that there should be no deemed exchange of the retained portion.

Sizing is potentially more complicated where the retained portion is significantly modified. Our preferred approach is to size the Section 108(e)(6) component by comparing the portion of the debt instrument that is contributed to capital to the total debt instrument. The Section 108(e)(10) component would constitute the remainder of the debt instrument. Under the Ratable Allocation approach that we recommend, AIP and basis would be allocated ratably between the two components in the same proportion as determined by the sizing of the components based on pre-contribution amounts.

We acknowledge that other allocation methodologies are possible. For example, one alternative (the "AIP-for-AIP" approach) treats the issue price of the new instrument as satisfying a dollar-for-dollar equivalent amount of the old instrument's AIP under Section 108(e)(10), with the remaining AIP treated as contributed under Section 108(e)(6). We do not adopt it; an approach of this kind necessarily concentrates AIP and basis in the Section 108(e)(6) contributed portion, which is the distortion the Ratable Allocation approach is designed to prevent.

We also acknowledge that our preferred allocation methodology tends to minimize CODI in one sense. That is, while the exchange portion (i.e., the portion to which Section 108(e)(10) applies) is sized, and AIP is allocated, based on pre-contribution amounts, CODI on this portion is determined looking to the post-contribution issue price of the retained portion. Such issue price may reflect the principal amount of the retained portion if the old debt instrument was not, and the retained portion is not, publicly traded. Where the retained portion is publicly traded, its post-contribution issue price may reflect an uplift in value resulting from the cancellation of the contributed portion. On balance, we do not believe that this factor substantially undercuts our preferred allocation methodology.

The fact that the retained portion's post-contribution value may reflect the creditor uplift produced by the contribution's own deleveraging is not bargained-for consideration but an incidental benefit of the contributor's own contribution; by analogy under the generalized-benefit principle of *Fink* that the Report adopts in Part IV.A.2 and consistent with the recommendation in Part IV.B that value accruing to the contributor through its continuing position not be treated as bargained-for consideration, such uplift does not convert a gratuitous contribution into a taxable exchange. If an adjustment were made to change the sizing of the Section 108(e)(6) and (e)(10) portions to negate the effect of the uplift (e.g., by sizing off the post-contribution value of the retained debt instrument), this could shift value from the Section 108(e)(6) component to the Section 108(e)(10) component and thereby treat the incidental effect of the uplift as CODI.

In addition, the creditor uplift on the retained portion is already accounted for once under the factor of the dominant-motivation test in Part IV.A.2 addressing the allocation of value

between creditor and equity positions (factor (d)), where it weighs against shareholder capacity. Because we recommend that the capacity determination be made on an all-or-nothing basis, a contribution that has satisfied that test has already absorbed whatever inference the creditor uplift supports, and the sizing and allocation discussed here are reached only after capacity is established. To let the same uplift drive the Section 108(e)(6)/Section 108(e)(10) sizing would count it a second time, penalizing the contributor again for value the all-or-nothing capacity test has already taken into account.

D. Additional Considerations with Sections 108(e)(6) and 108(e)(10) Overlap Transactions

The Section 108(e)(10) overlap raises an additional question with no counterpart on the Section 108(e)(8) side – namely, whether the significant-modification test of Treas. Reg. § 1.1001-3 should be applied to the retained portion alone or to the entire pre-contribution instrument, and how that choice interacts with Section 108(e)(6). In a transaction structured as a pure partial capital contribution, with no consideration returned to the contributing shareholder, a principal reduction may constitute a significant modification of the entire original debt instrument under Treas. Reg. § 1.1001-3(g) Example 3, producing a deemed exchange governed by Section 108(e)(10) rather than Section 108(e)(6) in its entirety. In effect, Section 108(e)(10) would leave no room for Section 108(e)(6) in partial contributions and create a cliff effect where a partial contribution is treated substantially worse than an entire contribution. To avoid this difficult-to-justify result, we believe that Section 108(e)(6) should govern the contributed portion and no Section 108(e)(10) deemed exchange under Treas. Reg. § 1.1001-3 should be triggered on the retained portion where there are no significant modifications made to the terms of the retained portion. This is discussed in Example V-3.

Where part of a debt is contributed to capital and the remainder is significantly modified within the meaning of Treas. Reg. § 1.1001-3, we believe that the contributed portion should be eligible for capital contribution treatment under Section 108(e)(6) and the remainder should be tested as a separate debt instrument under Treas. Reg. § 1.1001-3. If, on this basis, there is a significant modification of such separate debt instrument, it would be deemed exchanged for a new debt instrument under Section 108(e)(10). For the reasons stated in Part V.B., we favor this approach. This is discussed in Example V-4.

We note, however, that there is an alternative, intermediate approach (the "Hybrid Approach") that accepts whole-instrument significant-modification testing but does not allow it to displace Section 108(e)(6) for the contributed portion. On this view, the entire pre-contribution instrument is tested for significant modification under Treas. Reg. § 1.1001-3(g) Example 3, but a resulting deemed exchange does not dictate how the discharge between the debtor and the shareholder is characterized as between Section 108(e)(6) and Section 108(e)(10): the contributed portion remains eligible for Section 108(e)(6), and only the retained portion is treated as exchanged under Section 108(e)(10). It is the basis on which, even if whole-instrument testing were accepted, Section 108(e)(6) would continue to apply to the contributed portion rather than be displaced for the entire instrument. This is the approach applied as Approach 3 in Examples V-3 and V-4.

E. Examples of Overlap Under Sections 108(e)(6) and 108(e)(8)

The examples in this Part V.E illustrate the Divisibility Approach and Non-Divisibility Approach discussed in Part V.B applied to the overlap between Section 108(e)(6) (debt contributed to capital for no consideration) and Section 108(e)(8) (debt exchanged for stock) where both elements appear in a single transaction. Two configurations are presented: a non-wholly-owned shareholder structuring a transaction as partly a contribution and partly an exchange (Example V-1), and a shareholder structuring an economically identical transaction as a single exchange for stock below FMV (Example V-2). A separate threshold question — whether stock could be deemed issued where none was in fact issued, recharacterizing a pure Section 108(e)(6) contribution as a Section 108(e)(8) exchange — is addressed in Part IV.B Example IV-2 and not revisited here.

Example V-1: Partial debt contribution and partial exchange stock issued for remainder by 60-percent shareholder (FMV-for-FMV)

Facts. Shareholder-Creditor owns 60 percent of Debtor's outstanding stock; the remaining 40 percent is held by an unrelated minority shareholder ("Minority Shareholder"). Shareholder-Creditor holds debt of Debtor with an AIP, stated redemption price at maturity and basis of $120, and an FMV of $80, reflecting a distressed instrument. Shareholder-Creditor contributes 70 percent of its debt ($84 AIP with an allocable FMV of $56) to capital for no consideration in a transaction intended to be governed by Section 108(e)(6), and exchanges the remaining 30 percent ($36 AIP with an allocable FMV of $24) for stock of Debtor with an FMV of $24 in a transaction intended to be governed by Section 108(e)(8). The parties' designation allocates AIP/basis between the two portions consistent with the Ratable Allocation methodology (Part V.C). The shareholder capacity inquiry of Part IV.A.2 (i.e., dominant-motivation test) is assumed to be satisfied on these facts.

Discussion. This Example presents the divisibility question discussed in Part V.B on facts where the parties' AIP, basis and value track the value-based sizing and Ratable Allocation approach described in Part V.C and the contributor owns 60 percent rather than 100 percent of the debtor. The two general theories discussed in Part V.B produce the following results on these facts:

Under the Divisibility Approach, the contributed portion's $56 FMV is 70 percent of the $80 total, matching the 70 percent of AIP allocated to it, and the exchange portion's $24 FMV is 30 percent of the $80 total, matching the 30 percent of AIP allocated to it. No reallocation is required. The Section 108(e)(8) portion produces CODI of $12 ($36 AIP minus $24 FMV of stock received). The Section 108(e)(6) portion produces no CODI because the allocated basis of $84 equals the allocated AIP of $84. Total CODI is $12.

Under the Non-Divisibility Approach, the inclusion of a stock issuance in the same transaction displaces Section 108(e)(6) entirely, and the entire transaction is governed by Section 108(e)(8). CODI equals the full $120 AIP minus the $24 FMV of stock received, or $96. The textual predicate for the Non-Divisibility Approach is Section 108(e)(6)'s requirement that the debtor corporation acquire its indebtedness "as a contribution to capital." Where a restructuring

includes a stock issuance, the transaction in its entirety arguably takes on the character of an exchange rather than a contribution, and the statutory condition for Section 108(e)(6) (acquisition "as a contribution to capital") is not met for any portion of the instrument.[64]

Example V-2: Same facts as Example V-1 except no debt contribution in form and single exchange for below FMV stock

Facts. The facts are the same as in Example V-1 except that, rather than structuring the transaction as a partial contribution and partial exchange, Shareholder-Creditor exchanges all $120 AIP of its debt (with an FMV of $80) for stock of Debtor with an FMV of $24. No portion of the debt is explicitly contributed to capital or designated as a Section 108(e)(6) element.

Discussion. This Example presents the converse image of Example V-1: rather than the parties designating both the contributed and exchanged portions and the question being whether the designation is respected, the parties have structured the entire transaction as a single exchange and the question is whether a portion should be recharacterized as a constructive capital contribution. The $56 gap between the FMV of the debt transferred ($80) and the FMV of the stock received ($24) is the focal point: the analytical question is whether that gap should be treated as a deemed contribution governed by Section 108(e)(6), with the consequence that the corresponding portion of the AIP escapes the Section 108(e)(8) measurement.

Under the Divisibility Approach, and assuming the satisfaction of the value-based sizing and Ratable Allocation methodologies, the $56 FMV gap is properly recognized as a constructive capital contribution under generally applicable tax principles, regardless of the parties' formal designation. A shareholder who transfers debt to its corporation in exchange for stock worth less than the debt's FMV has by definition transferred value beyond what the exchange required, and that excess transfer is the kind of gratuitous shareholder-to-corporation value transfer that the contribution-to-capital doctrine treats as a contribution. The transaction is properly understood as a hybrid of an arm's-length exchange (to the extent of equivalent FMV) and a gratuitous contribution (to the extent of the FMV excess), with each component governed by the provision designed to address it. The value-based sizing and Ratable Allocation methodologies apply: the stock received ($24 FMV) covers 30 percent of the debt's $80 FMV, so 30 percent of AIP — $36 — is allocated to the Section 108(e)(8) portion, producing CODI of $12 ($36 AIP minus $24 FMV of stock). The remaining 70 percent of AIP — $84 — is allocated to the Section 108(e)(6) portion, with basis of $84 producing no CODI. Total CODI under this view is $12, the same result as Example V-1 (Divisibility Approach).

Under the Non-Divisibility Approach, the entire $120 AIP is governed by Section 108(e)(8) and the parties' choice of a single exchange form controls. Section 108(e)(6) by its terms requires that the corporation acquire its indebtedness "as a contribution to capital"; where the

[64] *See* Section 108(e)(8), which applies "[i]f a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness." The argument that the two provisions are mutually exclusive in a single transaction — rather than capable of governing separate components — is the core premise of the Non-Divisibility Approach as discussed in Part V.B.

parties have not structured any portion of the transaction as a contribution element, no Section 108(e)(6) portion exists. A substantive rationale reinforces this conclusion. A capital contribution requires a transaction structured to effect a transfer without consideration, and where the entire transaction is structured as an exchange of debt for stock, no portion has been so structured. Example V-1 is distinguishable on form grounds: there, the parties expressly designated a separate contributed portion, providing the formal element that the Non-Divisibility Approach holds to be necessary. CODI under this view equals $120 AIP minus $24 FMV of stock received, or $96.

The two approaches compared. Examples V-1 and V-2 present the same economic transaction in two forms: a designated partial contribution and partial exchange (V-1), and a single below-FMV exchange with no designated contribution element (V-2). The $56 gap between the debt's $80 FMV and the $24 of stock in V-2 is the same value that V-1 carves out and designates as its $84 AIP contributed portion; the only difference between the two Examples is whether the parties labeled that contribution component or left it to be supplied by substance. Under the Divisibility Approach that we recommend, both produce the same total CODI of $12, because the value-based sizing under Part V.C should recognize a contribution component to the extent the debt's fair market value exceeds the stock received, whether or not the parties designated one. Under the Non-Divisibility Approach, both instead produce CODI of $96 because the presence of a stock issuance is treated as governing the entire transaction under Section 108(e)(8), foreclosing any Section 108(e)(6) component. We recommend the Divisibility Approach. It ties the result to what was actually transferred: the exchange component is measured by the value of the stock actually received under Section 108(e)(8), and the residual transfer of value is treated as a contribution governed by Section 108(e)(6), consistent with the threshold recommendation in Part IV.B that an actual issuance or non-issuance of equity be respected consistent with the value-based sizing methodology of Part V.C. It also reaches the same result for economically identical transactions however they are documented. The Non-Divisibility Approach, by contrast, lets the presence of a stock issuance govern the entire instrument, subjecting even a substantively gratuitous contribution component to Section 108(e)(8) measurement, and produces the cliff effect described in Part V.B.

F. Examples of Overlap Under Sections 108(e)(6) and 108(e)(10)

The examples in this Part V.F address circumstances in which a shareholder contributes a portion of a single debt instrument to capital under Section 108(e)(6) while the remaining portion continues outstanding or is simultaneously modified. The interaction with Section 108(e)(10) arises because a principal reduction may constitute a significant modification under Treas. Reg. § 1.1001-3(e)(2), producing a deemed exchange of the original instrument for a new instrument with a reduced principal amount because of the resulting change in yield. Both examples present a divisibility question at their core: whether a single debt instrument can be severed into a contributed portion governed by Section 108(e)(6) and a retained portion analyzed separately — and the answer to that question determines whether, and to what extent, Section 108(e)(10) is reached.

Example V-3 presents that question in its simplest form: where the retained portion is not independently modified (and therefore no independent significant modification), the threshold

issue is whether the contribution of part of an instrument constitutes a modification of the part that remains because the contribution changes the yield of the whole pre-contribution instrument. Example V-4 presents the harder case: the retained portion is simultaneously modified. Moreover, even if divisibility is accepted, a further characterization question arises as to whether the significant modification rules of Treas. Reg. § 1.1001-3(e)(2) apply to the retained portion by analyzing the effect of the debt contribution on the whole pre-contribution debt instrument (the "whole-instrument modification test").

For the reasons described in Part V.B, we recommend that (i) the Divisibility Approach be applied to both Example V-3 and Example V-4 below, and (ii) the existence or absence of a significant modification be determined by testing the retained portion on its own terms as a separate debt instrument, without regard to the contributed portion (i.e., that the whole-instrument modification test does not apply). The implications of these recommendations are illustrated below.

Example V-3: Partial capital contribution; no modification of retained debt

Facts. Shareholder-Creditor owns 100 percent of the debt and equity of Debtor. The debt has a principal amount, stated redemption price at maturity, and AIP of $120 (the debt was issued without OID), a basis of $120, and an FMV of $80. Shareholder-Creditor contributes $90 of principal amount and AIP of the debt to capital for no consideration. The retained debt has a principal amount and AIP of $30 and is not modified in connection with the contribution. The debt is assumed to be publicly traded, and the retained debt is assumed to have a pre-contribution FMV of $20 and a post-contribution FMV of $25.

Discussion. This Example raises the question of how Section 108(e)(6) interacts with Treas. Reg. § 1.1001-3 and Section 108(e)(10) where the contributor contributes a portion of a single debt instrument to capital and the retained portion continues outstanding without independent modification. Three approaches have been advanced.

Under Approach 1 (Divisibility approach; retained instrument modification testing; partial contribution treatment), the $120 AIP debt instrument is treated as separable into distinct components for purposes of applying Section 108(e)(6) and Section 108(e)(10). Under the Ratable Allocation methodology (Part V.C), the contributed portion carries $90 of AIP and $90 of basis and the retained portion carries $30 of AIP and $30 of basis. The $90 contributed portion is then analyzed under Section 108(e)(6): because its allocated basis ($90) equals its allocated AIP ($90), the deemed-satisfaction amount under Section 108(e)(6)(B) produces no CODI. The retained $30 principal amount has a $30 AIP and is then independently tested for significant modification under Treas. Reg. § 1.1001-3, though this Example V-3 assumes no modification of the retained debt independent of the modification arising from the contribution.

No significant modification occurs with respect to the retained portion. The concern is that reducing the principal of the pre-contribution instrument changes its yield as a whole, which could be a significant modification if tested at the whole-instrument level. But once divisibility is accepted, the contribution is the retirement of a severed component, and the retained $30

instrument keeps its own original terms, so its yield, maturity, and payment schedule are unchanged. The yield change the concern depends on is an artifact of whole-instrument measurement, which the divisibility analysis does not apply. Where the retained portion's own terms are unmodified, Section 108(e)(10) is not triggered, and the retained $30 AIP instrument continues outstanding on its original terms. Total CODI under Approach 1 is $0. The pro rata prepayment analogy of Treas. Reg. § 1.1275-2(f) supports this treatment, as discussed in Part V.B. The IRS's administrative practice supports Approach 1 through the issuance of PLR 8844032 and PLR 202112003.[65]

Under Approach 2 (Non-divisibility approach; whole-instrument modification testing; no partial contribution), the partial contribution is treated as a significant modification of the entire $120 AIP instrument under Treas. Reg. § 1.1001-3. The instrument is a single instrument and a reduction in its principal balance is the type of modification that Treas. Reg. § 1.1001-3(e)(2) addresses — Treas. Reg. § 1.1001-3(g) Example 3 illustrates that a principal reduction can produce a yield change exceeding the applicable threshold, constituting a significant modification, and that example does not carve out cases where the reduction is effected by a shareholder contribution. On a significant modification finding, the old $120 AIP instrument is treated as exchanged for a new instrument. Because the debt is publicly traded, the issue price of the new instrument equals its FMV after the partial contribution, which we assume to be $25, thereby generating CODI of $95 ($120 AIP minus $25 issue price/FMV) under Section 108(e)(10). In support of Approach 2, it can be argued that the specific-over-general canon does not cleanly resolve the priority question in favor of Section 108(e)(6): Section 108(e)(10) is itself a specific provision addressing deemed exchanges arising from debt modifications, and its application here is not a case of a general rule overriding a specific one but rather a case of two specific provisions addressing overlapping fact patterns, with Section 108(e)(10) reflecting Treasury's and the IRS's considered regulatory judgment about how principal reductions should be treated. Total CODI under Approach 2 is $95.

Under Approach 3 (Hybrid divisibility approach; whole-instrument modification testing; with partial contribution), the significant-modification analysis under Treas. Reg. § 1.1001-3 is performed at the level of the entire $120 instrument, as under Approach 2, but Section 108(e)(6) is given effect on the contributed portion, so that any deemed exchange under Section 108(e)(10) reaches only the retained portion rather than the entire instrument. Approach 3 performs whole-instrument testing for the modification analysis while applying divisibility for the CODI computation, in contrast to Approach 1, which applies divisibility at both stages, and Approach 2, which applies whole-instrument treatment at both stages. This Approach 3 thus treats the divisibility and significant-modification questions as separate inquiries rather than collapsing one into the other, applying a whole-instrument unit of analysis to the modification question and a

[65] PLR 8844032 (Aug. 8, 1988) (ruling that a shareholder's contribution of a specified dollar amount of debt to the capital of an insolvent corporation was governed by Section 108(e)(6), with the debtor recognized as having satisfied the contributed portion of the debt with an amount equal to the shareholder's basis; no analysis of Section 108(e)(10) consequences for the retained balance was undertaken); PLR 202112003 (Dec. 29, 2020) (ruling that a foreign parent's partial forgiveness of intercompany debt was governed by Section 108(e)(6) without triggering a Section 108(e)(10) deemed exchange of the entire instrument; the IRS applied Section 108(e)(6) to the forgiven portion without treating the retention of the remaining balance as a significant modification of the original instrument).

divisible unit to the measurement. That separation is what allows Approach 3 to preserve Section 108(e)(6) on the contributed portion even under whole-instrument testing, though, as discussed in the comparison of the approaches below, applying different units of analysis at the two stages is also the feature that makes Approach 3 harder to justify than Approach 1. Under this approach, the $90 contributed portion is governed by Section 108(e)(6) and produces no CODI (basis $90 equals AIP $90), and the retained AIP $30 portion, if treated as exchanged, is measured against the issue price of the new instrument. On the facts of this Example, the retained portion's issue price equals $25 (its post-contribution FMV per the facts), so the Section 108(e)(10) CODI on the retained portion is $5.

Example V-4: Partial capital contribution with simultaneous modification of retained debt.

Facts. The facts are the same as in Example V-3, except that the retained $30 AIP debt is simultaneously modified in connection with the partial contribution — for example, through a change in yield (separate from any change in yield arising from the partial capital contribution), extension of maturity, or change in payment terms. The modified instrument has an issue price equal to its post-contribution FMV of $20. As in Example V-3, the debt is assumed to be publicly traded.

Discussion. This Example raises the question of how the analysis discussed in Example V-3 operates where the retained portion is itself simultaneously modified. The simultaneous modification makes this a harder case than Example V-3. Treas. Reg. § 1.1001-3 generally tests modification at the instrument level: a change to part of an instrument is tested against the terms of the entire instrument, not merely the altered portion (absent a Treas. Reg. § 1.1275-2(f) pro rata prepayment divisibility argument). Unlike Example V-3, the independent ground that the retained portion's terms are unmodified is not available here. Three approaches have been advanced.

Under Approach 1 (Divisibility approach; retained instrument modification testing; partial contribution treatment), the $120 AIP instrument is treated as divisible. Because the instrument is uniform before the contribution, the sizing methodology of Part V.C. coincides with the contribution itself, producing a 75/25 split. Also, under the Ratable Allocation methodology (Part V.C), the $90 contributed portion and the $30 retained portion bear AIP and basis in proportion to their respective 75 percent and 25 percent shares of the original $120 debt instrument, so the contributed portion carries $90 of AIP and $90 of basis and the retained portion carries $30 of AIP and $30 of basis. The $90 contributed portion is analyzed under Section 108(e)(6) and produces no CODI (allocated basis $90 equals allocated AIP $90). The retained $30 AIP portion is then independently tested for significant modification under Treas. Reg. § 1.1001-3, with the modification tested against the terms of the original $30 AIP component of the instrument — not against the terms of the original $120 AIP instrument. If the modification, tested against the terms of the original $30 AIP component, does not meet the applicable threshold — for example, if the change in yield is de minimis when measured against that component's terms — no CODI arises on the retained portion and total CODI is $0. If the modification is significant, the retained portion is treated as exchanged for a new instrument with issue price of $25, generating Section 108(e)(10) CODI of $5 ($30 AIP minus $25 issue price).

Under Approach 2 (Non-divisibility approach; whole-instrument modification testing; no partial contribution), the partial contribution and the contemporaneous modification of the retained portion are treated as an integrated alteration of a single $120 AIP instrument, tested for significant modification at the whole-instrument level under Treas. Reg. § 1.1001-3. If the integrated transaction produces a significant modification (which is likely on facts where the modification would pass the change-in-yield threshold standing alone), the original $120 AIP instrument is treated as exchanged for a new instrument with an issue price equal to its FMV of $25, generating CODI of $95 ($120 AIP minus $25 issue price/FMV) under Section 108(e)(10).

Under Approach 3 (Hybrid divisibility approach; whole-instrument modification test; with partial contribution), the integrated transaction triggers a significant modification of the entire $120 AIP instrument under Treas. Reg. § 1.1001-3, but Section 108(e)(6) is preserved for the $90 contributed portion. The sizing and Ratable Allocation methodologies apply as they do in Approach 1. The contributed portion carries $90 of AIP and $90 of basis and produces no CODI under Section 108(e)(6)(B). The $30 retained portion carries $30 of AIP and is treated as exchanged for a new instrument with an issue price equal to its post-modification FMV of $25, producing CODI of $5 under Section 108(e)(10) ($30 AIP minus $25 issue price).

The three approaches compared. The same three approaches are presented in Example V-3 and Example V-4, and the considerations bearing on them are common to both. We recommend Approach 1. It applies divisibility consistently at both the modification-testing and the measurement stages, treating the contributed and retained portions as the separate instruments the Divisibility Approach holds them to be, and it alone gives Section 108(e)(6) its intended effect on the contributed portion without importing whole-instrument consequences. Approach 1 is, however, the most difficult to reconcile with Treas. Reg. § 1.1001-3, which ordinarily tests a modification against the terms of the entire instrument rather than a severed portion; it depends on first severing the retained portion under the pro rata prepayment analogy of Treas. Reg. § 1.1275-2(f) and then testing modification against that portion's own terms. We accept that difficulty because the alternative of whole-instrument testing produces results that are harder to justify, as the other two approaches illustrate.

Approach 2 produces the cliff effect described in Part V.B: on the facts of these Examples, a partial contribution generates CODI of $95, approaching the result for a complete cancellation, even though a contribution of the entire $120 instrument should generate no CODI under Section 108(e)(6). Subjecting the contributed portion to whole-instrument measurement in this way is difficult to reconcile with the policy of Section 108(e)(6) and is the principal reason we do not adopt it.

Approach 3 avoids that cliff by preserving Section 108(e)(6) for the contributed portion while applying the whole-instrument modification test. Whether it reaches the same result as Approach 1 depends on the facts. In Example V-4, where the retained portion is independently and significantly modified against its own terms, both approaches treat the retained portion as exchanged and reach the same $5 of CODI. In Example V-3, where the retained portion's own terms are unmodified, the two diverge: Approach 1 produces no CODI, because the retained portion has not been significantly modified on its own terms, while Approach 3 still treats it as

exchanged because the whole-instrument test is met. That divergence is the practical consequence of testing the whole instrument rather than the retained portion alone for the modification inquiry. It is, however, in some tension with the decision to permit divisibility at all: it treats the instrument as a single instrument for the modification inquiry but as divisible for the CODI measurement, and a rule that applies different units of analysis at the two stages is harder to justify on principle than one that applies the same unit at both. We note Approach 3 as a coherent intermediate position, and it could be argued that it may be more readily reconciled with Treas. Reg. § 1.1001-3(g) Example 3 than Approach 1. However, for the reasons stated above and illustrated by Example V-3, we prefer Approach 1.