Bankruptcy & Insolvency Taxation

Third Edition

Grant W. Newton

Robert Liquerman

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BANKRUPTCY & INSOLVENCY TAXATION

Third Edition

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Although Chapters 2, 5, 6, and 7 reflect the views of Robert Liquerman, they do not necessarily reflect the views of KPMG, LLP.

IMPORTANT NOTE

As we go to press, Congress is on the verge of passing new legislation that will affect corporate bankruptcy. Please email Sheck Cho at John Wiley & Sons (*scho@wiley.com*) to receive information about this new Act.

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Preface

This book is designed to provide a broad range of guidance on the tax aspects of decisions that must be made by companies in financial trouble. It will be useful to financial advisors, accountants, lawyers, trustees, turnaround professionals, examiners, creditors, bankruptcy judges, and debtors-in-possession.

The tax provisions of the Internal Revenue Code (I.R.C.) and the Bankruptcy Code applicable to businesses that have filed a chapter 7 or a chapter 11 bankruptcy petition are discussed in detail. Also explained are the provisions of the debtor and its creditors. Special attention is given to the I.R.C. sections contained in the Tax Reform Act of 1980 and revisions of these sections by subsequent legislation, including the Tax Reform Act of 1984 and 1986, the Revenue Act of 1987, the Technical and Miscellaneous Revenue Act of 1988, the Revenue Reconciliation Act of 1990, the Omnibus Budget Reconciliation Act of 1993, Taxpayer Relief Act of 1977, the Job Creation and Worker Assistance Act of 2002, and other public laws related to taxes as well as other areas involving tax law changes.

The first edition of *Bankruptcy and Insolvency Taxation* was a revision of the authors' *Tax Planning for the Troubled Business*, first published in 1983 and revised annually. This edition, revising the second edition, will be updated annually or more frequently if needed because of tax law changes. *Bankruptcy and Insolvency Taxation* is one of four books by the author and published by John Wiley & Sons dealing with bankruptcy and insolvency taxation and accounting. The others are *Bankruptcy and Insolvency Accounting: Practice and Procedure*, *Bankruptcy and Insolvency Accounting: Forms and Exhibits,* and *Corporate Bankruptcy.*

Chapter 1 describes the general provisions of the Bankruptcy Code applicable to debtors who have filed a chapter 7 or chapter 11 petition. Chapter 2 contains a discussion of how the debtor accounts for the tax impact of debt discharge, including the exchange of stock for debt. Included is a description of regulations issued dealing with basis adjustment and debt modifications. Chapter 3 deals with the tax impact of an out-of-court workout or bankruptcy proceeding in a partnership or an S corporation, including a discussion of the Supreme Court decision in *Gitlitz* and subsequent legislation changes overturning *Gitlitz.* Chapter 4 examines the basic procedures that apply to the tax returns that must be filed by individuals, partners, and corporations in a chapter 7 or a chapter 11 case. The carryover of tax attributes, including regulations issued dealing with gain on sale of residence, to the estate of an individual debtor created when the bankruptcy petition is filed, and the subsequent succession of the tax attributes by the debtor once the case has been completed are also explained.

Chapter 5 examines tax-free reorganizations under I.R.C. section 368, with special emphasis on type "G" reorganization, established by the Bankruptcy Tax Act of 1980. The use of net operating loss carryovers and other tax attributes by companies that go through a complete internal reorganization, or that are reorganized by the use of another corporation, is the subject of Chapter 6. Both

Chapters 5 and 6 contain a detailed discussion of the many regulations and rules issued to implement the relevant provisions of the Internal Revenue Code.

Chapter 7 discusses several corporate tax topics not covered in previous chapters, including: liquidations, the use of I.R.C. section 338, incorporation under I.R.C. section 351, and the determination of whether an issue is debt or stock.

Chapter 8 deals with the state and local tax impact of income from debt discharge and related areas that are important for state and local tax purposes.

Chapter 9 covers the tax impact that reorganization and income from debt discharge may have on the creditors.

Tax procedures are described in Chapter 10, tax priorities and discharge are examined in Chapter 11, and Chapter 12 contains a discussion of tax preferences and liens.

Chapters 2 through 7 and 9 through 12 have been updated to reflect cases that have been decided and pronouncements that have been issued by the IRS since the Second Edition was published.

Included in the Appendixes are relevant sections of the Internal Revenue Code and related sections of legislative history.

This author acknowledges the many contributions made by coauthor Gilbert D. Bloom, Esq., in the Washington National Tax Practice of KPMG, LPP, over a period of almost 20 years beginning with the first volume published in 1983, and welcomes Robert L. Liquerman, also with the National Tax Practice of KPMG, LLP, as coauthor.

Comments from users are welcomed.

Grant W. Newton
Malibu, California
March 2005

Mr. Liquerman appreciates the assistance provided by Christine W. Booth and Mary Van Leuven, also in the Washington National Tax Practice of KPMG, LLP, in preparing this edition. He also thanks his many other colleagues at KPMG, LLP, for their insights and contributions in preparing this book.

Robert Liquerman

CHAPTER ONE

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§ 1.1 OBJECTIVES

(a) Introduction

The income tax effect of certain transactions during the administration period and of tax assessments related to pre-bankruptcy periods can impose undue hardship on the bankrupt, who is already in a tenuous financial position. It is not uncommon for a bankrupt to realize substantial taxable income during the administration period from the sale of all or part of the assets or from taxable recoveries. Net operating loss carryovers and other offsetting tax deductions are often unable to minimize the income tax effect. Therefore, in addition to

ensuring that all statutory tax reporting and filing requirements are satisfied at the due dates, the accountant must be aware of those tax aspects that will permit the preservation and enlargement of the bankrupt's estate.

During the closing days of the 96th Congress, the Bankruptcy Tax Act of 1980 was passed as Public Law 96-589 and signed by President Carter on December 24, 1980. This bill eliminated a great deal of the uncertainty about handling debt forgiveness and other tax matters, as the Bankruptcy Code superseded the sections of the Bankruptcy Act that contained provisions for nonrecognition of gain from debt forgiveness along with other related tax items. The Bankruptcy Code contains state and local tax law but no federal tax provisions. The new Bankruptcy Tax Act was passed after some last-minute compromises. Included was an amendment that delayed until January 1, 1982, the requirement that net operating losses be reduced by the amount of debt that is forgiven. This was designed to allow one year for Congress to consider comments from the public regarding the handling of debt forgiveness. Sections of the Bankruptcy Tax Act and other sections of the Bankruptcy Code relating to the tax issues of troubled businesses were changed by the several tax reform acts since it was passed.

The purpose of this book is to analyze in detail the tax ramifications of bankruptcy and insolvency proceedings and to provide a practical guide that will assist financial advisors, accountants, attorneys, and other related professionals in rendering tax services in the liquidation and rehabilitation of financially troubled debtors in and out of bankruptcy court. The book should be of interest to debtors, business turnaround professionals, trustees, appraisers, and other professionals who assist debtors or creditors of debtors that are experiencing financial difficulty. While these professionals may not be directly involved in rendering professional tax services, they must be aware of the tax consequences of many decisions they make or recommend in bankruptcy cases or out-of-court settlements.

(b) Scope of Coverage

This book describes the tax aspects of a separate estate created for individuals in a chapter 7 or 11 case. The tax ramifications of discharge of debt in and out of bankruptcy court are discussed for both the debtor and creditors. A full chapter is devoted to a discussion of the use of net operating losses by corporations. Tax priorities, assessments, discharges, and authority in bankruptcy are described in the last three chapters.

The Bankruptcy Tax Act significantly changed the ways in which a corporation can be reorganized in a bankruptcy proceeding. The new type "*G*" reorganization created under the Act is analyzed, along with the other aspects of tax reorganization. Other special tax problems are described, such as impact of debt forgiveness on the earnings and profit account and tax issues related to partnerships and S corporations.

The balance of this chapter describes briefly the nature of out-of-court settlements and reorganization or liquidation in a title 11 bankruptcy case. This discussion is intended only to provide the reader with a basic introduction to

out-of-court and bankruptcy proceedings. For a more detailed discussion of the legal aspects of and the accounting for out-of-court settlements and bankruptcy cases, see Newton's *Bankruptcy and Insolvency Accounting: Practice and Procedure* (Wiley; updated annually).

§ 1.2 ALTERNATIVES AVAILABLE TO A FINANCIALLY TROUBLED BUSINESS

A debtor's first alternatives are to locate new financing, to merge with another company, or to find some other basic solution to its situation in order to avoid the necessity of discussing its problem with representatives of creditors. If none of these alternatives is possible, the debtor may be required to seek a remedy from creditors, either informally (out of court) or with the help of judicial proceedings.

(a) Out-of-Court Settlements

An out-of-court settlement is an informal agreement that usually consists of an extension of time (stretch-out), a pro rata cash payment for full settlement of claims (composition), an issue of stock for debt, or some combination of these methods. The debtor, through a counselor credit association, calls an informal meeting of the creditors for the purpose of discussing its financial problems. In many cases, the credit association makes a significant contribution to the out-of-court settlement by arranging a meeting of creditors, providing advice, and serving as secretary for the creditors' committee.

A credit association is composed of credit managers of various businesses in a given region. Its functions are to provide credit and other business information to member companies concerning their debtors, to help make commercial credit collections, to support legislation favorable to business creditors, and to provide courses in credit management for members of the credit community. At the creditors' meeting, the debtor will describe the causes of failure, discuss the value of assets (especially those unpledged) and unsecured liabilities, and answer any questions the creditors may ask. The main objective of this meeting is to convince the creditors that they would receive more if the business were allowed to operate than if it were forced to liquidate and that all parties would be better off if a settlement could be worked out.

(i) Creditors' Committee

To make it easier for the debtor to work with the creditors, a committee of creditors may be appointed during the initial meeting of the debtor and its creditors, providing, of course, the case is judged to warrant some cooperation by the creditors. The creditors are often as interested in working out a settlement as is the debtor.

There is no set procedure for the formation of a committee. Ideally, the committee should consist of four or five of the largest creditors and one or two representatives from the smaller creditors. A lot of time wasted on deciding the size and composition of the committee would be saved at creditors' meetings if the

committees were organized routinely in this manner. However, there are no legal or rigid rules defining the manner in which a committee may be formed. Although a smaller creditor may often serve on a committee, there are committees on which only the larger creditors serve, either because of lack of interest on the part of the smaller creditors or because the larger creditors override the wishes of others.

The debtor's job of running the business while under the limited direction of the creditors' committee can be made easier if the creditors selected are those most friendly to the debtor.

(A) Duties of Committee

The creditors' committee serves as the bargaining agent for the creditors, supervises the operation of the debtor during the development of a plan, and solicits acceptance of a plan once it has been approved by the committee. Generally, the creditors' committee will meet as soon as it has been appointed, for the purpose of electing a presiding officer and counsel. The committee will also engage a financial advisor to help the members understand the nature of the debtor's problems and evaluate the debtor's business plan.

At the completion of the audit, the creditors' committee will meet to discuss the results. If the audit reveals that the creditors are dealing with a dishonest debtor, the amount of settlement that will be acceptable to the creditors will be increased significantly. It becomes very difficult for a debtor to avoid a bankruptcy court proceeding under these conditions. However, if the debtor is honest and demonstrates the ability to reverse the unprofitable operations trend and reestablish the business, some type of plan may eventually be approved.

(ii) Plan of Settlement

It is often advisable, provided there is enough time, for the financial advisor and the attorney to assist the debtor in preparing a suggested plan of settlement so it can be presented and discussed at the first meeting with creditors. Typically, only the largest creditors and a few representatives of the smaller creditors are invited in order to avoid having a group so large that little can be accomplished.

There is no set form that a plan of settlement proposed by the debtor must take. It may call for 100 percent payment over an extended period of time, payments on a pro rata basis in cash for full settlement of creditors' claims, satisfaction of debt obligations with stock, or some combination. A carefully developed forecast of projected operations, based on realistic assumptions developed by the debtor with the aid of its accountant, can help creditors determine whether the debtor can perform under the terms of the plan and operate successfully in the future.

Generally, for creditors to accept a plan, the amount they will receive must be at least equal to the dividend they would receive if the estate were liquidated. This dividend, expressed as a percentage, is equal to the sum of a forced-sale value of assets, accounts receivable, cash, and prepaid items minus priority claims, secured claims, and expenses of administration divided by the total amount of unsecured claims.

The plan should provide that all costs of administration, secured claims, and priority claims, including wages and taxes, are adequately disposed of for the eventual protection of the unsecured creditors. If the debtor's plan includes a cash down payment in full or partial settlement, the payment should at least equal the probable dividend the creditors would receive in bankruptcy.

(iii) Acceptance of Plan

After the creditors' committee approves a plan, it will notify all the other creditors and recommend to them that they accept the plan. Even if a few creditors do not agree, the debtor should continue with the plan. The dissenting creditors will eventually have to be paid in full. Some plans even provide for full payment to small creditors, thus destroying the nuisance value of the small claims. In an informal agreement, there is no provision binding the minority of creditors to accept the will of the majority. Thus, it is necessary to obtain the approval of almost all of the creditors in order for an out-of-court settlement to be successful.

(iv) Advantages and Disadvantages

Summarized below are a few of the reasons why the informal settlement is used in today's environment:

- The out-of-court settlement is less disruptive to a business that continues operating.
- The debtor can receive considerable benefits from the advice of a committee, especially if some of the committee members have extensive business experience, preferably but not necessarily in the same line of business.
- The informal settlement avoids invoking the provisions of the Bankruptcy Code and, as a result, more businesslike solutions can be adopted.
- Frustrations and delays are minimized because problems can be resolved properly and informally without the need for court hearings.
- An agreement can usually be reached much faster informally than in court proceedings.
- The costs of administration are usually less in an out-of-court settlement than in a formal reorganization.

The weaknesses of informal composition settlements are:

- A successful plan of settlement requires the approval of substantially all creditors, and it may be difficult to persuade distant creditors to accept a settlement that calls for payment of less than 100 percent.
- The assets of the debtor are subject to attack while a settlement is pending. (The debtor can, of course, point out to the creditors that if legal action is taken, a petition in bankruptcy court will have to be filed.)
- The informal composition settlement does not provide a method to resolve individual disputes between the debtor and the creditors.
- Executory contracts, especially leases, may be difficult to avoid.

- Certain tax law provisions make it more advantageous to file a bankruptcy court petition.
- Priority debts owed to the United States under Rev. Stat. section 3466 must be paid first.

(b) Assignment for Benefit of Creditors

A remedy available under state law to a corporation in serious financial difficulties is an *assignment for the benefit of creditors.* In this instance, the debtor voluntarily transfers title to its assets to an assignee, which then liquidates them and distributes the proceeds among the creditors. Assignment for the benefit of creditors is an extreme remedy because it results in the cessation of the business. This informal liquidation device (although court-supervised in many states) is like the out-of-court settlement devised to rehabilitate the debtor, in that it requires the consent of all creditors or at least their agreement to refrain from taking action. The appointment of a custodian over the assets of the debtor gives creditors the right to file an involuntary bankruptcy court petition.

Proceedings brought in the federal courts are governed by the Bankruptcy Code. Normally, it will be necessary to resort to such formality when suits have been filed against the debtor and its property is under garnishment or attachment or is threatened by foreclosure or eviction.

(c) Bankruptcy Court Proceedings

Bankruptcy court proceedings are generally the last resort for a debtor whose financial condition has deteriorated to the point where it is impossible to acquire additional funds. When the debtor finally agrees that bankruptcy court proceedings are necessary, the liquidation value of the assets often represents only a small fraction of the debtor's total liabilities. If the business is liquidated, the creditors get only a small percentage of their claims. The debtor is discharged of its debts and is free to start over; however, the business is lost and so are all the assets. Normally, liquidation proceedings result in large losses to the debtor, to the creditor, and to the business community in general. Chapter 7 of the Bankruptcy Code covers the proceedings related to liquidation. Another alternative under the Bankruptcy Code is to seek some type of relief so that the debtor will have enough time to work out agreements with creditors with the help of the bankruptcy court and be able to continue operations. Chapters 11, 12, and 13 of the Bankruptcy Code provide for this type of operation

Title 111[1] of the U.S. Code contains the bankruptcy law. The code is divided into eight chapters:

Chapter 1: General Provisions

Chapter 3: Case Administration

Chapter 5: Creditors, the Debtor, and the Estate

[1] The Bankruptcy Code as originally passed consisted of only odd-numbered chapters. In 1986, Congress added chapter 12.

Chapter 7: Liquidation

Chapter 9: Adjustment of Debts of a Municipality

Chapter 11: Reorganization

Chapter 12: Adjustment of Debts of a Family Farmer with Regular Income

Chapter 13: Adjustment of Debts of an Individual with Regular Income

Chapters 1, 3, and 5 apply to all proceedings under the code, except in chapter 9, where only those sections of chapters 1, 3, and 5 specified apply. A case commenced under the Bankruptcy Code's chapters 7, 9, 11, 12, or 13 is referred to as a *title 11 case.*

(d) Provisions Common to All Bankruptcy Proceedings

A voluntary case is commenced by the filing of a bankruptcy petition under the appropriate chapter by the debtor. An involuntary petition can be filed by creditors with aggregate unsecured claims of at least $12,300[2] and can be initiated only under chapter 7 or 11. If there are 12 or more creditors with unsecured claims, at least three creditors must sign the petition; if the number of unsecured creditors is less than 12, a single creditor can force the debtor into bankruptcy. Only one of two requirements must be satisfied in order for the creditors to force the debtor into bankruptcy:

1. The debtor generally fails to pay its debts as they become due, or
2. Within 120 days prior to the petition, a custodian was appointed or a custodian took possession of substantially all of the debtor's property.

(i) Automatic Stay

A petition filed under the Bankruptcy Code results in an automatic stay of the actions of creditors. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or its property, regardless of where the property is located, until the stay is modified or removed. The debtor or the trustee is permitted to use, sell, or lease property (other than cash collateral) in an ordinary course of business without a notice or hearing, provided the business has been authorized to operate in a chapter 7, 11, 12, or 13 proceeding and the court has not restricted the powers of the debtor or trustee in the order authorizing operation of the business.

In bankruptcy proceedings, the debtor or trustee also has the power to assume or reject any executory contract or any unexpired lease of the debtor.

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[2] Many of the dollar amounts in the Bankruptcy Code are increased to reflect the change in the Consumer Price Index for all Urban Consumers for the most recent three-year period ending immediately before January 1 of the year that the three-year interval begins on April 1. The amounts are to be rounded to the nearest $25 dollar amount. Effective April 1, 2004, the minimum amount needed to file an involuntary petition was established at $12,300. The $12,300 value remains effective until April 1, 2007.

(ii) Priorities

The 1978 Bankruptcy Code modified to a limited extent the order of payment of the expenses of administration and other unsecured claims. Section 507 of the Bankruptcy Code provides for the following priorities:

1. Administrative expenses.
2. In an involuntary case, unsecured claims arising after commencement of the proceedings but before an order of relief is granted.
3. Wages earned within 90 days prior to filing the petition (or to the cessation of the business) to the extent of $4,925 per individual.
4. Unsecured claims to employee benefit plans arising within 180 days prior to filing the petition, but limited to $4,925 times the number of employees less the amount paid in priority 3 above.
5. Unsecured claims of grain producers against grain storage facilities and claims of fishermen against product storage or processing facilities to the extent of $4,925 for each such individual.
6. Unsecured claims of individuals to the extent of $2,225 from deposits of money for purchase, lease, or rental of property or purchase of services not delivered or provided.
7. Claims for alimony, maintenance, and support due but not paid.
8. Unsecured tax claims of governmental units (discussed in more detail in chapter 11).
9. Allowed unsecured claims based on any commitment by the debtor to regulation agencies of the federal government to maintain the capital of an insured depository institution.

(iii) Discharge of Debts

The Bankruptcy Code contains provisions that allow an individual debtor in a chapter 7, 11, or 12 proceeding to have its debts discharged. A corporation may also have its debts discharged in chapter 11 or 12; however, these debts cannot be discharged in a chapter 7 or 11 liquidation. Chapter 13 has some special provisions that deal with the discharged of debt and allow additional taxes to be discharged that could not be discharged in a chapter 7 or 11 proceeding. Included among debts that may not be discharged are certain types of taxes. These taxes will be discussed in Chapter 11 of this text.

(iv) Preferences

The Bankruptcy Reform Act of 1978 substantially modified the handling of preferential payments. Section 547 of the Bankruptcy Code provides that a trustee or debtor-in-possession can avoid transfers that are considered preferences. The trustee may avoid any transfer of property of the debtor:

- To or for the benefit of a creditor.
- For or on account of an antecedent debt owed by the debtor before such transfer was made.

- Made while the debtor was insolvent.
- Made:
  - On or within 90 days before the date of the filing of the petition, or
  - Between 90 days and one year before the date of the filing of the petition if such creditor, at the time of such transfer, was an insider
- That enables such creditor to receive more than it would receive if
  - The case were a case under chapter 7 of this title,
  - The transfer had not been made, or
  - Such creditor received payment of such debt to the extent provided by the provisions of this title.

Note that for an *insider*, the debtor can go back an entire year to void the transfer. However, the one year only applies to an insider and not to a third party. For example, if the president of the debtor company paid a bank loan 100 days prior to the filing of the petition, action to recover the preference could be taken against the president, but not against the bank.

Certain exemptions apply to preferential payments. One of these is a contemporaneous exchange: an exchange (payment) for new value, such as inventory not previously received, is given to the debtor. For example, the purchase of goods or services with payment by check or cash would not be a preferential payment. The second exemption protects payments of debts that are incurred in the ordinary course of business or financial affairs of both the debtor and the transferee, when the payment is made in the ordinary course of business according to ordinary business terms. For example, a 30-day open account for utility service would be sheltered provided payment is made according to the normal terms (such as 30 days) and according to ordinary business terms. Security interests granted in exchange for enabling loans, when the proceeds are used to finance the purchase of specific personal property, are also exempt. This exception would allow creditors to isolate from preference attack, a transfer received, to the extent that the creditors replenish the estate with new value. For example, if a creditor received $10,000 in preferential payments and subsequently sold goods with a value of $6,000 to the debtor on unsecured credit, the preference would be only $4,000.

(e) Chapter 7: Liquidation

Chapter 7 is used only when the corporation sees no hope of being able to operate successfully or to obtain the necessary creditor agreement. Under this alternative, the corporation is liquidated and the remaining assets are distributed to creditors after administrative expenses are paid. An individual debtor may be discharged from liabilities and entitled to a fresh start.

The decision as to whether rehabilitation or liquidation is best also depends on the amount to be realized from each alternative. The method resulting in the greatest return to the creditors and stockholders should be chosen. The amount to be received from liquidation depends on the resale value of the firm's assets minus the costs of dismantling and legal expenses. The value of the firm after

rehabilitation must be determined (net of the costs of achieving the remedy). The alternative leading to the highest value should be followed.

Financially troubled debtors often attempt an informal settlement or liquidation out of court, but if it is unsuccessful they will then initiate proceedings under the Bankruptcy Code. Other debtors, especially those with a large number of creditors, may file a petition for relief in the bankruptcy court as soon as they recognize that continuation of the business under existing conditions is impossible. As will be discussed later, the debtor may also liquidate by filing a plan of liquidation under chapter 11.

(i) Appointment of Trustee

As soon as the order for relief has been entered, the U.S. trustee will appoint a disinterested party from a panel of private trustees to serve as the interim trustee. The functions and powers of the interim trustee are the same as those of an elected trustee. Once an interim trustee has been appointed, at a meeting of creditors the creditors will elect a trustee that will be responsible for liquidating the business. If a trustee is not elected by the creditors, the interim trustee may continue to serve in the capacity of the trustee and carry through with an orderly liquidation of the business.

The duties of the trustee are defined in section 704 of the Bankruptcy Code. They include:

- Collect and reduce to money the property of the estate for which such trustee serves and close up such estate as expeditiously as is compatible with the best interests of parties in interest.
- Be accountable for all property received.
- Investigate the financial affairs of the debtor.
- If a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper.
- If advisable, oppose the discharge of the debtor.
- Unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest.
- If the business of the debtor is authorized to be operated, file with the court and with any governmental unit charged with responsibility for collection or determination of any tax arising out of such operation, periodic reports and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the court requires.
- Make a final report and file a final account of the administration of the estate with the court.

The objective of the trustee will be to liquidate the assets of the estate in an orderly manner. Once the property of the estate has been reduced to money and the security claims to the extent allowed have been satisfied, then the property

of the estate shall be distributed to the holders of the claims in an order as specified by the Bankruptcy Code. The first order, of course, would be priority claims, and once these claims have been satisfied, the balance will go to unsecured creditors. After all the funds have been distributed, the remaining debts of an individual will be discharged. As mentioned earlier, if the debtor is a corporation, the debts will not be discharged. Thus, it will be necessary for the corporation to cease existence. Any funds subsequently coming into the corporate shell would be subject to attachment.

(f) Chapter 11: Reorganization

The purpose of chapter 11 is to provide the debtor with court protection, allow the debtor (or trustee) to continue the operations of the business while a plan is being developed, and minimize the substantial economic losses associated with liquidations. Chapter 11 as provided for in the Bankruptcy Code was designed to provide the flexibility of Chapter XI under prior law, yet it contains several of the protective provisions of the old Chapter X. It is designed to allow the debtor to use different procedures depending on the nature of the debtor's problem and the needs of the creditors. Agreements under this chapter can affect unsecured creditors, secured creditors, and stockholders. A voluntary or involuntary petition can be filed under chapter 11. Upon the filing of the involuntary petition, the court may, on request of an interested party, authorize the appointment of a trustee. The appointment is not mandatory and the debtor may, in fact, continue to operate the business as if a bankruptcy petition had not been filed, except that certain transactions may be avoided under the Bankruptcy Code. If the creditors prove the allegations set forth in the involuntary petition, an order for relief is entered, and the case will proceed in a manner identical to that of a voluntary case.

(i) Creditors' Committee

The Bankruptcy Code provides that a creditors' committee will be appointed consisting of the seven largest unsecured creditors willing to serve or, if a committee was organized before the order for relief, such a committee may continue provided it was chosen fairly and is representative of the different kinds of claims. The purpose of the creditors' committee is very similar to that of a creditors' committee appointed in an out-of-court settlement. The U.S. trustee appoints the committee. The creditors' committee normally acts as the bargaining agent for the larger creditor body and continues to see that the assets of the debtor are protected.

(ii) Operation of Business

The debtor will continue to operate the business unless a party in interest requests that the court authorize the appointment of a trustee. The U.S. trustee will make the appointment, if authorized by the court. Once the appointment has been authorized, the creditors also have the right to elect a trustee, rather than have one appointed by the U.S. Trustee. It is not necessary for an order to be granted to allow the debtor to continue to operate the business.

(iii) Disclosure Statement

A party cannot solicit the acceptance or rejection of a plan from creditors and stockholders affected by the plan unless they are given a written disclosure statement containing adequate information, as approved by the court. Section 1125(b) of the Bankruptcy Code requires that this disclosure statement must be provided prior to or at the time of the solicitation. The disclosure statement must be approved by the court, after notice and a hearing, as containing adequate information.

Section 1125(a) states that adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor, typical of holders of claims or interests of the relevant class, to make an informed judgment about the plan. This definition contains two parts. First it defines adequate information, and then it sets a standard against which the information is measured. It must be the kind of information that a typical investor of the relevant class, not one that has special information, would need to make an informed judgment about the plan.

(iv) Developing the Plan

In cases where the debtor is allowed to operate the business as debtor-in-possession, the debtor has 120 days after the order for relief to file a plan and 180 days after the order for relief to obtain acceptance before others can file a plan. These time periods may be extended or reduced by the court. The Bankruptcy Code allows the debtor to file a liquidation rather than a reorganization plan where liquidation for various reasons may be more appropriate for the debtor. For example, during 2001 and 2002 over one-third of all public company plans confirmed were liquidation plans. Many of them were plans where the assets were sold in a section 363 sale under the provisions of the bankruptcy court and the proceeds distributed to the creditors in a liquidation plan.

Section 1123 of the Bankruptcy Code lists the items that are required to be included in the plan. They are:

1. Designate classes of claims and interests.
2. Specify any class of claims or interests that is not impaired under the plan.
3. Specify the treatment of any class of claims or interests that is impaired under the plan.
4. Provide the same treatment for each claim or interest in a particular class unless the holders agree to less favorable treatment.
5. Provide adequate means for the plan's execution, such as:
   - **(a)** Retention by the debtor of all or any part of the property of the estate,
   - **(b)** Transfer of all or any part of the property of the estate to one or more entities,
   - **(c)** Merger or consolidation of the debtor with one or more persons (individuals, partnerships, and corporations),

- **(d)** Sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate,
- **(e)** Satisfaction or modification of any lien,
- **(f)** Cancellation or modification of any indenture or similar instrument,
- **(g)** Curing or waiving of any default,
- **(h)** Extension of a maturity date or a change in an interest rate or other term of outstanding securities,
- **(i)** Amendment of the debtor's charter,
- **(j)** Insurance of securities of the debtor, or of any entity involved in a merger or transfer of the debtor's business for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose.

6. Provide for the inclusion in the charter of the debtor, if the debtor is a corporation, or of any corporation referred to in 5(a) or (b) above, of a provision prohibiting the issuance of nonvoting equity securities, and provide, as to the several classes of securities possessing voting power, an appropriate distribution of such power among such classes, including, in the case of any class of equity securities having a preference over another class of equity securities with respect to dividends, adequate provisions for the election of directors representing such preferred class in the event of default in the payment of such dividends.

In addition to the mandatory requirements listed above, the plan may provide for certain permissible provisions. They include:

- Impair or leave unimpaired any class of unsecured or secured claims or interests.
- Provide for the assumption or rejection of executory contracts or leases.
- Provide for settlement or adjustment of any claim or interest of the debtor or provide for the retention and enforcement by the debtor of any claim or interest.
- Provide for the sale of all of the property of the debtor and the distribution of the proceeds to the creditors and stockholders.
- Include any other provision not inconsistent with the provisions of the Bankruptcy Code.

(v) Confirmation of the Plan

Section 1129(a) of the Bankruptcy Code contains the requirements that must be satisfied before a plan can be confirmed. The provisions are summarized below:

1. **The plan complies with the applicable provisions of title 11.** Bankruptcy Code section 1122, concerning classification of claims, and section 1123, on the content of the plan, are two of the significant sections that must be followed.

2. **The proponents of the plan comply with the applicable provisions of title 11.** Section 1125 of the Bankruptcy Code, on disclosure, is an example of a section that is referred to by this requirement.
3. **The plan has been proposed in good faith and not by any means forbidden by law.**
4. **Payments are disclosed.** Any payment made or promised for services, costs, and expenses in connection with the case or plan has been disclosed to the court; payments made before confirmation are reasonable; and those to be made after confirmation must be subject to the court's approval.
5. **Officers are disclosed.** The proponent of the plan must disclose those who are proposed to serve after confirmation as director, officer, or voting trustee of the reorganized debtor. Such employment must be consistent with the interests of creditors and equity security holders and with public policy. Names of insiders to be employed and the nature of their compensation must also be disclosed.
6. **Regulation rate approval has been obtained.** Any regulatory commission that will have jurisdiction over the debtor after confirmation of the plan must approve any rate changes provided for in the plan.
7. **The-best-interest-of-creditors test has been satisfied.** It is necessary for the creditors or stockholders who do not vote or if voted, did not vote in favor of the plan to receive as much as they would if the business were liquidated under chapter 7.
8. **Each class has accepted the plan.** Each class of creditors that is impaired under the plan must accept the plan. Section 1129(b) provides an exception to this requirement.
9. **Claims are treated in their order of priority.** This requirement provides the manner in which priority claims must be satisfied unless the holders agree to a different treatment.
10. **Acceptance by at least one class has been obtained.** At least one class that is impaired, other than a class of claims held by insiders, must accept the plan.
11. **The plan is feasible.** Confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization unless such liquidation or reorganization is provided for in the plan. This requirement means that the court must ascertain that the debtor has a reasonable chance of surviving once the plan is confirmed and the debtor is out from under the protection of the court. A well-prepared forecast of future operations based on reasonable assumptions, taking into consideration the changes expected as a result of the confirmation of the plan, is an example of the kind of information that can be very helpful to the court in reaching a decision on this requirement.
12. **Payment of fees has been arranged.** All quarterly and filing fees must have been paid or the plan must provide that payment will be made on the effective date.
13. **Retiree benefits will continue.** The plan must provide for the continuation of payments of retiree benefits as required under section 1114 of the Bankruptcy Code.

As noted in requirement 8, for a plan to be confirmed, a class of claims or interests must either accept the plan or not be impaired. However, subsection (b) of Bankruptcy Code section 1129 allows the court, under certain conditions, to confirm a plan even though an impaired class has not accepted the plan. The plan must not discriminate unfairly and must be fair and equitable with respect to each class of claims or interest impaired under the plan that has not accepted it. The Bankruptcy Code states conditions for secured claims, unsecured claims, and stockholder interests that would be included in the *fair and equitable* requirement.

(vi) Discharge of Debts

Once the plan has been confirmed, the Bankruptcy Code provides for discharge of the debts. This would include both individual and corporate debts. However, section 523 of the Bankruptcy Code provides that some debts of individuals may not be discharged. Among the debts that will not be discharged under section 523 are tax claims that have a priority under section 507 of the Bankruptcy Code and taxes for years in which a return was not filed, was filed late and within two years before the petition was filed, or was filed fraudulently.

(vii) Advantages of Chapter 11

Chapter 11 proceedings may be more appropriate under certain conditions than informal settlements made out of court. Some of Chapter 11's advantages are:

- Rather than near-unanimous approval, majority approval in number or two-thirds in amount of allowed claims of creditors' voting is sufficient to accept a plan of reorganization and bind dissenters.
- Creditors bargain collectively with the debtor, which may result in more equitable treatment of the members of each class of claims or interests.
- The debtor's assets are in the custody of the court and safe from attack when the petition is filed.
- Executory contracts and leases can be cancelled when such action benefits the debtor.
- Financing during the reorganization may be easier to obtain.
- The creditors have an opportunity to investigate the debtor and its business affairs.
- Certain preferential and fraudulent transfers can be avoided by the debtor-in-possession or trustee.
- Proper protection can be provided to holders of public securities.
- Certain tax advantages are available under the Bankruptcy Code.
- Creditors are additionally protected by the requirement that, to be confirmed by the court, the plan must be in the best interests of creditors; be feasible; be fair and equitable to any impaired, dissenting classes; and provide for priority claims.

(viii) Prepackaged or Prenegotiated Chapter 11 Plans

Before filing a chapter 11 plan, some debtors develop and obtain approval of the plan by all impaired claims and interests. The court may accept the voting that

was done prepetition provided that the solicitation of the acceptance (or rejection) was in compliance with applicable nonbankruptcy law governing the adequacy of disclosure in connection with the solicitation. If no nonbankruptcy law is applicable, then the solicitation must have occurred after or at the time the holder received adequate information as required under section 1125 of the Bankruptcy Code.

It is necessary for a chapter 11 plan to be filed for several reasons, including:

- Income from debt discharge is taxed in an out-of-court workout to the extent that the debtor is or becomes solvent. Some tax attributes may be reduced in a bankruptcy case, but the gain from debt discharged is not taxed.
- The provisions of section 382(1)(5) and section 382(1)(6) of the Internal Revenue Code (I.R.C.) apply only to bankruptcy cases (see § 6.24(g)).
- Some bond indenture agreements provide that amendments cannot be made unless all holders of debt approve the modifications. Because it is difficult, if not impossible, to obtain 100 percent approval, it is necessary to file a bankruptcy plan to reduce interest or modify the principal of the bonds.

Recently, "prenegotiated bankruptcies" have been used in certain conditions rather than prepackaged bankruptcies. Under a prenegotiated plan, an agreement is reached with creditors before the petition is filed. Often the plan and disclosure statement are filed with the court at the time the petition is filed or shortly thereafter. Once the court has approved the disclosure statement the plan and disclosure statement are issued and votes are solicited. Under the prenegotiated plan, the disclosure for public companies is in the form of a disclosure statement rather than SEC filing requirements.

(g) Chapter 12: Adjustment of Debts of a Family Farmer with Regular Annual Income

To help farmers resolve some of their financial problems, Congress passed chapter 12 of the Bankruptcy Code. It became effective November 26, 1986, and lasted until October 1, 1993. Because chapter 12 is new and relates to a specific class of debtors, Congress wanted to evaluate whether the chapter is serving its purpose and whether there is a need to continue this special chapter for the family farmer. Congress was expected evaluate the need for chapter 12 within a reasonable time period. Congress recently extended the life of chapter 12 to July 1, 2005. Most family farmers could not file under chapter 13 because they had too much debt to qualify; they were limited to chapter 11. However, the distinction between the dollar amounts of the debt was much greater than it is today. Many farmers had found chapter 11 needlessly complicated, unduly time-consuming, inordinately expensive, and, in too many cases, unworkable.[3] Chapter 12 is

[3] H.R. Rep. No. 958, 99th Cong., 2d Sess. 48 (1986).

designed to give family farmers an opportunity to reorganize their debts and keep their land. According to legislative history, debtors under chapter 12 receive the protection from creditors that bankruptcy provides, while at the same time preventing abuse of the system and ensuring that farm lenders receive a fair repayment.[4]

Section 1204 of the Bankruptcy Code allows the debtor to operate the farm unless the bankruptcy court orders otherwise. Only the debtor can file a plan in a chapter 12 case. The requirements for a plan in chapter 12 are more flexible and lenient than those in chapter 11.

(h) Chapter 13: Adjustment of Debts of an Individual with Regular Income

The Bankruptcy Reform Act of 1978 changed Chapter XIII of the Bankruptcy Act to make it extremely attractive for individual owners of small businesses. Prior to the new law, only employees (wage earners) were allowed to file according to the provisions of the Bankruptcy Act. In addition, some courts allowed pension fund or social security recipients, and some self-employed individuals, such as carpenters, to seek relief under Chapter XIII; other courts interpreted the Act very narrowly, allowing only employees to file a petition. The objective of chapter 13 is to provide individuals with some alternative other than liquidation when in financial trouble. Chapter 13 allows the individual, with court supervision, to work out a plan that can provide for full or partial payment of debts over an extended period of time. The plan is similar in concept to a chapter 11 reorganization but on a less formalized and more practical scale.

Individuals with secured or unsecured claims over certain dollar amounts are not allowed to file under chapter 13. The Bankruptcy Reform Act of 1994 increased the debt limits of chapter 13 cases for both secured and unsecured debt and provided for an increase in the debt limit every three years based on the Consumer Price Index for all Urban Consumers. The dollar amount as of April 1, 2004 was $307,675 for unsecured debt and $922,975 for secured debt. These dollar values are effective through March 31, 2007.

The definition of regular income requires that individuals filing the petition must have sufficient stable and reliable income to enable them to make payments under the chapter 13 plan. The limit on amount of indebtedness will prevent some wage earners from filing a petition. The purpose, however, of this limitation was to allow some small sole proprietors to file under this chapter (the filing of a chapter 11 petition might be too cumbersome for them) and require the larger individually owned businesses to use chapter 11.

In re Maxfield,[5] the bankruptcy court held that a section 6672 penalty assessed against the debtor for failure to pay the withholding taxes of Meridian Glass did count toward the debt limit.

The bankruptcy court held that the IRS's disputed claim is includable in calculating the chapter 13 debt limits under section 109(e) of the Bankruptcy Code.

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[4] *Id.*

[5] 4.1 159 B.R. 587 (Bankr. D. Idaho 1993).

The taxpayers claimed that a proof of claim filed by the IRS for $338,500 was discharged in an earlier chapter 7 case. The bankruptcy court held that the objection to the proof of claim was irrelevant. The court noted that section 109(e) requires only that the debt be noncontingent and liquidated. In this case, the tax debt clearly was noncontingent, because it arose from the taxpayers' failure to pay by the due dates. The court hypothesized that excluding disputed debts from the section 109(e) debt limits would encourage debtors to dispute every unsecured claim to satisfy the chapter 13 eligibility requirements. The court also noted that the tax obligation was not discharged in the prior chapter 7 cases because the taxpayers never sought to have it discharged.[6] The bankruptcy court rejected the argument advanced by the debtor that the claim was secured because it was secured with the assets of Meridian. The court ruled that the IRS claim was unsecured with regard to the bankruptcy estate. The bankruptcy court also rejected the argument that the claim was contingent by noting that the IRS was not required to collect from Meridian before collecting the penalty from the responsible person, which is the debtor in bankruptcy.

(i) Operation of Business

Section 1304 of the Bankruptcy Code provides that the debtor in a chapter 13 case will be allowed to continue to operate the business unless the court orders otherwise. In addition, the debtor has the responsibility of an operating trustee to file the necessary reports and other required information with the appropriate taxing authorities. To operate the business, it is necessary for the debtor to have control over its property. Section 1306(b) of the Bankruptcy Code provides that the debtor will remain in possession of all the property of the estate. The code also provides that the property of the estate includes, in addition to the property as of the date the petition was filed, all property acquired after the commencement of the case and earnings from services rendered before the case is closed.

(ii) Chapter 13 Plan

Only the debtor can file a plan in a chapter 13 case. The requirements for a plan in chapter 13 are much more flexible and lenient than those in chapter 11. In fact, only three requirements set forth in the Bankruptcy Code must be met:[7]

1. The debtor must submit to the supervision and control of the trustee all or such part of the debtor's future earnings as is necessary for the execution of the plan.
2. The plan must provide for full payment, in deferred cash payments, of all priority claims unless the creditors agree to a different treatment.
3. Where creditors are divided into classes, the same treatment must apply to all claims in a particular class.

[6] *In re Ekeke*, 198 B.R. 315 (Bankr. E.D. Mo. 1996).
[7] 11 U.S.C. § 1322(a).

Once the plan has been approved and confirmed by the court, the debts will be discharged. The extent to which debts can be discharged under chapter 13 is much greater than it is in chapter 11 procedures.

Individuals owning businesses that can file in either chapter 13 or chapter 11 may find some advantages in using chapter 13: chapter 13 has much less creditor involvement. In a chapter 11 proceeding, the debtor runs a risk of a trustee being appointed, but in chapter 13 the debtor will operate the business even though there is a standing trustee. Less creditor approval is also required in a chapter 13 case than in a chapter 11 proceeding.

(i) U.S. Trustee

In October 1986, Congress passed the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, which expands the ten pilot programs to 21 regions comprising all federal districts except districts in the states of Alabama and North Carolina. A U.S. trustee, serving a term of five years, is appointed in each of the regions. The U.S. trustee appoints creditors' committees, chapter 7 trustees, and chapter 11 trustees or examiners when authorized by the court when such appointments are needed. Section 586(a) of title 28 of the U.S. Code lists these additional functions of the U.S. trustee:

- Monitor applications for compensation and reimbursement for officers filed under section 330 of title 11 and, whenever the U.S. trustee deems it to be appropriate, file with the court comments with respect to any of such applications.
- Monitor plans and disclosure statements filed in cases under chapter 11 and file with the court comments with respect to such plans and disclosure statements.
- Monitor plans filed under chapters 12 and 13 of title 11 and file with the court comments with respect to such plans.
- Take such action as the U.S. trustee deems to be appropriate to ensure that all reports, schedules, and fees required to be filed under title 11 and this title by the debtor are filed properly and in a timely manner.
- Monitor creditors' committees appointed under title 11.
- Notify the appropriate U.S. attorney of matters related to the occurrence of any action that may constitute a crime under the laws of the United States and, on the request of the U.S. attorney, assist the U.S. attorney in carrying out prosecutions based on such action.
- Monitor the progress of cases under title 11 and take such actions as the U.S. trustee deems to be appropriate to prevent undue delay in such progress.
- Monitor applications filed under section 327 of title 11 for the retention of accountants and other professionals and, whenever the U.S. trustee deems it to be appropriate, file with the court comments with respect to the approval of such applications.
- Perform other duties that the Attorney General may prescribe.

CHAPTER TWO

Discharge of Indebtedness

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§ 2.1 INTRODUCTION

One major source of income in most insolvency and bankruptcy proceedings is debt cancellation. Section 61 of the Internal Revenue Code (I.R.C.) lists discharge of indebtedness as one item subject to tax, and the Treasury Regulations (Treas. Reg.), at section 1.61-12(a), provide that the discharge of indebtedness, in whole or in part, may result in the realization of income. Prior to the codification of the general principle that debt cancellation is income, debt cancellation was deemed to produce income under the Supreme Court's decision in *United States v. Kirby Lumber Co.*[1] The Supreme Court held that the debtor realized income under two interrelated theories. First, the debtor realized an accession to income due to the transaction. Second, under a freeing-of-the-assets theory, assets previously offset by liabilities were "freed" by the transaction.

Several exceptions to this basic policy evolved since the *Kirby Lumber* decision. For example, a cancellation of indebtedness may be more appropriately characterized as a contribution to capital, distribution, gift, or purchase price adjustment. The Bankruptcy Tax Act of 1980 codified some of these exceptions, rejected or conditioned the availability of others, and introduced additional provisions addressing whether and to what extent particular transactions give rise to discharge of indebtedness income. Before discussing the current discharge of indebtedness provisions, the manner in which debt cancellation was handled in prior law will be summarized.

§ 2.2 DISCHARGE OF INDEBTEDNESS INCOME

The treatment of income from the discharge of indebtedness was of particular interest to the drafters of the Bankruptcy Tax Act of 1980. Their chief concern was that taxation of such income would reduce the amount available to satisfy the claims of creditors who, in most cases, were already receiving less than 100 percent of their claims.

The Bankruptcy Tax Act amended I.R.C. section 108 to apply to bankruptcy proceedings as well as to out-of-court settlements. Prior to this amendment, I.R.C. section 108 applied only to discharge of indebtedness out of court. I.R.C. section 108(a), as amended by the Tax Reform Act of 1986[2] and subsequent statutory amendments, provides that income from discharge of debt can be excluded from gross income under any one of the following conditions:[3]

- The discharge occurs in a title 11 case.[4]
- The discharge occurs when the taxpayer is insolvent. [5]
- The indebtedness discharged is qualified farm indebtedness.[6]

[1] 284 U.S. 1 (1931).

[2] Prior to the Tax Reform Act of 1986, an exception was also provided for "qualified business indebtedness." I.R.C. section 108(d)(4) (1982).

[3] *See* § 2.9(a) for a discussion of consolidated return regulations providing that the I.R.C. § 108(a) exclusions are not available for certain intercompany obligations.

[4] I.R.C. § 108(a)(1)(A).

[5] I.R.C. § 108(a)(1)(B).

[6] I.R.C. § 108(a)(1)(C).

- The indebtedness discharged is qualified real property business indebtedness.[7]

Exclusion of income under these provisions must be accompanied by a reduction of tax attributes. Attribute reduction and other consequences of qualifying for income exclusion under I.R.C. section 108(a) are discussed in detail later in this chapter (§ 2.7 (a)-(d)).

Before income can be excluded under I.R.C. section 108(a), it must be properly characterized as income from the discharge of indebtedness under I.R.C. section 61(a)(12) ("DOI income")[8], and not operating income or gain on an exchange. Numerous cases and rulings have addressed this issue. The Bankruptcy Tax Act of 1980 codified (and/or altered) some judicial approaches to whether particular transactions give rise to DOI income. Although this codification should logically have been added to I.R.C. section 61(a), it was instead added to I.R.C. section 108(e).

The remainder of this chapter will discuss whether particular income is DOI income, focusing first on representative cases and rulings under I.R.C. section 61(a)(12), and then on the provisions of I.R.C. section 108(e) that explicitly expand and contract the scope of DOI income. Having determined which income is DOI income, the chapter will then turn to whether that income is excluded from gross income under one of four exclusions for title 11 cases, insolvency, qualified farm indebtedness, and qualified real property business indebtedness. The discussion will then address the consequences of coming within the purview of I.R.C. section 108(a). The chapter will consider the unique issues raised by the use of mortgaged property to cancel debts. The chapter will address specific rules that are provided in the consolidated return regulations. If the consolidated return regulations apply, the tax consequences of a debt cancellation may be different than the tax consequences initially discussed in the following sections. Finally, the chapter will address specific filing requirements.

§ 2.3 DETERMINATION OF DISCHARGE OF INDEBTEDNESS INCOME

(a) What Is Discharge of Indebtedness Income?

I.R.C. section 61(a)(12) includes in gross income "income from the discharge of indebtedness." The basic concept of DOI income may be illustrated by example. A debtor borrows $100 from a creditor who later accepts $60 from the debtor in complete satisfaction of the $100 debt. In this simple example, the debtor has $40 in DOI income. Before discussing the ramifications of DOI income, the threshold issue is whether DOI income exists in a particular transaction. As demonstrated by cases and rulings, one of three characterizations generally prevails: DOI income, income other than DOI income, or no income.

(i) In General

DOI income arises when a creditor releases a debtor from an obligation that was incurred at the outset of the debtor-creditor relationship. In *United States v. Cen-*

[7] I.R.C. §§ 108(a)(1)(D), 108(c).
[8] Also referred to by some authors as cancellation of debt (COD) income.

tennial Savings Bank FSB,[9] the Supreme Court held that the imposition of an early withdrawal penalty on certificates of deposit (CDs) was not the discharge of an obligation to repay. When customers deposited money and the bank issued CDs, debtor-creditor relationships were created between the bank and the depositors. Like most CDs, the terms and conditions of the instruments included an interest rate, maturity date, and early withdrawal penalty.

Focusing on the meaning of "discharge," the Supreme Court found that "discharge of indebtedness" conveys the forgiveness of, or the release from, an obligation to repay. A depositor who cashed in a CD before the maturity date and paid the early withdrawal penalty did not forgive or release any obligation of the bank. By paying principal and interest, less the penalty, the bank paid exactly what it was obligated to pay under the terms of the CD agreement. Although the bank has income equal to the amount of the penalty, the income is not from the release of an obligation incurred by the bank at the outset of its debtor-creditor relationship with the depositor. The Supreme Court held that to determine whether the debtor has realized DOI income, "it is necessary to look at *both* the end result of the transaction *and* the repayment terms agreed to by the parties at the outset of the debtor-creditor relationship."[10]

The standard used in *Centennial Savings Bank* was applied to a different transaction, but had the same result, in *Phillip Morris Inc. v. Commissioner*.[11] Phillip Morris borrowed an amount of foreign currency from a bank. Before Phillip Morris repaid the loan, the value of the dollar increased relative to the borrowed foreign currency. When Phillip Morris paid back the amount of foreign currency it had borrowed, it used a stronger dollar (i.e., it converted fewer dollars into the foreign currency) to satisfy its obligations.

Phillip Morris did realize a "foreign exchange gain" on the repayment of the foreign currency loan, but the gain was not DOI income. The Tax Court noted that "the teaching of *Centennial Savings* is clear, namely that the discharge of an indebtedness may be an occasion for the realization of income but, unless there is a cancellation or forgiveness of a portion of the indebtedness *not reflected in the terms of the indebtedness*, such income is not discharge of indebtedness income. . . ."[12] Because Phillip Morris' foreign exchange gain resulted from favorable conditions in the currency market, rather than a forgiveness or release of its obligations under the foreign currency loan, DOI income did not exist.[13]

Phillip Morris is representative of the far-reaching impact of *Centennial Savings*. Before *Centennial Savings*, the courts had generally held that foreign exchange gain was DOI income. One example of this was *Kentucky & Indiana Terminal Railroad Co. v. United States*.[14] The *Phillip Morris* decision specifically notes

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[9] 499 U.S. 573 (1991).
[10] *Id*. at 581.
[11] 71 F.3d 1040, *aff'g* 104 T.C. 61 (1995).
[12] 104 T.C. 61, 73 (1995) (emphasis added).
[13] Foreign exchange gain is generally income under a provision of section 988 that did not exist when Phillip Morris incurred the gain.
[14] 330 F.2d 520 (6th Cir. 1964).

that *Centennial Savings* undermines the continued viability of *Kentucky & Indiana Terminal Railroad Co.*[15]

(ii) Discharge of Recourse and Nonrecourse Debt

The cancellation of either recourse or nonrecourse debt may trigger DOI income.[16] In basic terms, debt is recourse if the debtor is personally liable for the amount due; debt is nonrecourse if the debtor is not personally liable for the debt, that is, the creditor can only look to the property securing the debt if the debtor defaults.

The next cases involve the satisfaction and assumption of mortgages on real property. *In re Collum*[17] is another example of what is not DOI income based on *Centennial Savings*. *Collum* involves the sale of real property that is subject to a recourse mortgage (i.e., the mortgagor is personally liable for the debt). The Collums sold the property to a corporation that assumed the mortgage; however, the couple was not released from liability. The court held that gain, not DOI income, was realized on the sale of the property.

The extant cases discussed so far demonstrate what is *not* DOI income. The next decision is an example of what is DOI income—a discount received on the prepayment of a recourse mortgage. Generally, satisfaction of a mortgage on a taxpayer's residence for less than the amount due creates DOI income.[18] *Michaels v. Commissioner*[19] involves the Michaels's sale of their primary residence. In connection with the sale of the house, the mortgage balance was discounted by 25 percent. The Michaels included the discount as part of the capital gain on the sale, which was deferred under I.R.C. section 1034 when the couple purchased a more expensive residence. The Michaels argued unsuccessfully that, because the mortgage payment was an integral part of the sale of the residence and because the buyer's funds were used to prepay the mortgage, the discount should be taken into account in calculating the gain realized, but not recognized due to I.R.C. section 1034. The Tax Court held that the discount was income from the discharge of indebtedness separate from the sale of the property.

The Supreme Court issued *Centennial Savings* after the Tax Court issued *Michaels*, so it is possible that the subsequent decision undermines the precedential value of *Michaels*, as in *Kentucky & Indiana Terminal Railroad* discussed in § 2.3(a)(i). This is not likely, however, because the facts of *Michaels* do not indicate that the discount was part of the terms of the mortgage.

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[15] *Phillip Morris*, 71 F.3d at 1043; 104 T.C. at 72-73.

[16] "Indebtedness" for purposes of I.R.C. section 108 includes debts for which the taxpayer is liable (recourse debt) or debts on property owned by the taxpayer, such as a nonrecourse mortgage on real property. I.R.C. § 108(d). Given this definition, both recourse and nonrecourse debts should be subject to the provisions of I.R.C. section 108. For more detail, *see* §2.8.

[17] 131 B.R. 793 (Tex. N.D. 1991), *aff'd*, 84 F.3d 433 (5th Cir. 1996).

[18] *See, e.g., DiLaura v. Commissioner*, 53 T.C.M. (CCH) 1077 (1987); *Juister v. Commissioner*, 53 T.C.M. (CCH) 1079 (1987), *aff'd*, 875 F.2d 864 (6th Cir. 1989).

[19] 87 T.C. 1412 (1986).

(iii) Transfer or Repurchase of Debt

DOI income may be realized when the debtor repurchases outstanding debt at a bargain price. This occurred in the 1931 landmark *United States v. Kirby Lumber Co.*[20] decision. The Supreme Court held that the debtor realized DOI income under two interrelated theories. First, the debtor realized an accession to income due to the transaction. Second, under a freeing-of-the-assets theory, assets previously offset by liabilities were "freed" by the transaction.

The calculation of income on the repurchase of debt is currently addressed in Treas. Reg. section 1.61-12(c)(2)(ii), which provides that "[a]n issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of Treas. Reg. § 1.1275-1(b)). The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price."[21]

The reference to the original issue discount provisions (Treas. Reg. section 1.1275-1(b)) for the determination of adjusted issue price was added to the regulations in 1998.[22] Interestingly, this amendment was a stealth regulatory reversal of *United States Steel Corp. v. United States*[23] and *Fashion Park, Inc. v. Commissioner*.[24] Both cases involved fact patterns that are similar to the following scenario. Assume that a corporation issued preferred stock for $100 and the value of the preferred stock increases in value to $165. The corporation redeems the preferred stock with $165 in debt. The corporation later repurchases the debt for $120.

Fashion Park, a 1954 decision, preceded any regulation on DOI income from the repurchase of debt. Based on *Kirby Lumber* and *Rail Joint Co. v. Commissioner*,[25] the Tax Court held that the corporation did not have any income when

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[20] 284 U.S. 1 (1931).

[21] Although calculation of the adjusted issue price is the more controversial part of this equation, sometimes the valuation of the repurchase price is at issue. For example, in *Yamamoto v. Commissioner*, the taxpayer owed $1.6 million to one corporation and was owed $1.7 million by another corporation. The taxpayer owned both the creditor corporation and the debtor corporation. To satisfy his $1.6 million obligation, the taxpayer assigned the $1.7 million note from the debtor corporation to the creditor corporation. The court found that the fair market value of the $1.7 million note was zero, that is, no one would purchase the note due to the poor financial condition of the debtor corporation. Because the taxpayer used a worthless note to satisfy his $1.6 million obligation to the creditor corporation, he had DOI income of $1.6 million when the worthless note was assigned. *Yamamoto v. Commissioner*, 60 T.C.M. (CCH) 1050 (1990), *aff'd*, 958 F.2d 380 (9th Cir. 1992).

[22] T.D. 8746, 62 Fed. Reg. 68173 (Dec. 31, 1997).

[23] 848 F.2d 1232 (Fed. Cir. 1988), *rev'g* 11 Ct. Cl. 375 (1986).

[24] 21 T.C. 600 (1954), *nonacq*. 1955-2 C.B. 10.

[25] 22 B.T.A. 1277 (1931), *nonacq.*, 1931-2 C.B. 99, *aff'd*, 61 F.2d 751 (2d Cir. 1932). *Rail Joint* is an important early decision that applied the accession-to-wealth theory, discussed by the courts in both *Fashion Park* and *United States Steel*. However, *Rail Joint* involved a different factual situation, a corporation's repurchase of bonds originally issued to its shareholders as dividends. The corporation did not realize DOI income because there was no freeing of assets. The analysis in *Rail Joint* could be different under a later-enacted I.R.C. section 108(e)(6). *See* § 2.4(b).

it repurchased debt for less than its face value because there was no increase in the corporation's assets.

A 1988 case, *United States Steel*, involved a fact pattern and result similar to *Fashion Park*—no DOI income based on the freeing-of-assets theory. When *United States Steel* was decided, the then-current regulations generally provided that DOI income from the repurchase of debt was equal to the excess of the issue price (without reference to the original issue discount rules) over the repurchase price.[26] The IRS argued that the *issue price* of the debt was the market value of the preferred stock when the debt was issued ($165 in the example), resulting in DOI income equal to the issue price less the repurchase price ($165 – $120 = $45). The Federal Circuit was not persuaded by this argument and held that the issue price of the debt was the amount the corporation received when it originally issued the preferred stock for $100, noting that it was not necessary to determine *issue price* by reference to the original issue discount rules. Consequently, the Federal Circuit found no DOI income on the debt repurchase.

United States Steel would not have the same outcome under the current regulations; rather, the position the IRS had taken in that case would prevail and the debtor would have DOI income. Under Treas. Reg. section 1.61-12(c)(2)(ii), the calculation of the issue price is determined under the original issue discount rules, which results in $45 DOI income ($165 issue price less $120 repurchase price). This 1998 change was made as part of a larger regulatory package without mention of the *United States Steel* decision in the accompanying preamble.

(iv) Income Other Than Discharge of Indebtedness

Cancellation of debt may be the medium through which other types of income arise, if the relationship of the parties is more than debtor-creditor—such as employer and employee, shareholder and corporation, or buyer and seller of property. The characterization and tax consequences of the transaction depend on the relationship of the parties and the context in which the discharge occurs. In *Spartan Petroleum Co. v. United States*,[27] for example, a reduction of a debt was simply viewed as the means used to pay for property.

Debtors may set off obligations, as illustrated by the following example. Mr. X owes Mr. Y $100 and Mr. Y also owes Mr. X $100. Rather than paying each other $100, the two debts are set off against each other. Neither has DOI income. The Bankruptcy Code generally preserves a creditor's right to offset mutual obligations between the creditor and a bankrupt debtor. In an analogous vein, in *OKC Corp. v. Commissioner*,[28] the Tax Court held that a cancellation of debt was merely a means of settling a claim. The IRS reached a similar conclusion in Rev. Rul. 84-176,[29] finding that cancellation of debt in exchange for a release of a contract counterclaim does not result in DOI income.

If a corporation makes a bona fide loan to a shareholder, or a corporation acquires a shareholder's debt from a third party, and the corporation

[26] Treas. Reg. § 1.61-12(c)(3) (1972).
[27] 437 F.Supp. 733 (D.S.C. 1977).
[28] 82 T.C. 638 (1984).
[29] 1984-2 C.B. 34.

subsequently cancels the shareholder's obligation, the cancellation may be a distribution.[30] The amount of the distribution may not be equivalent to the amount of the debt cancelled, however. Assume that on January 1, 2000 a corporation loaned its sole shareholder $100 with a 10-year term to maturity. The debt bore a 5 percent rate of interest, payable annually, which reflected a market rate of interest. On January 1, 2004, the corporation cancelled the $100 principal obligation. At this time, interest rates in the market had risen to 9 percent. Assume that the value of the debt (a $100 receivable in the hands of the corporation) dropped to $85 as a result of the rise in interest rates. I.R.C. section 301(b) provides that the amount of any distribution is the fair market value of the money received by the shareholder, plus the fair market value of the other property received. One approach suggested by revenue rulings is to bifurcate the transaction. That is, the debt cancellation results in a distribution to the extent of the fair market value of the debt ($85) and DOI income with respect to the remainder ($15).[31] This bifurcation concept may also apply to loans between employers and employees. Another approach ignores the difference between the amount of the debt and its fair market value and treats the face amount of the debt as the amount of the distribution.[32]

The cancellation of an obligation between an employer and an employee may be a payment for services.[33] If an employer makes a bona fide loan to an employee and in a later year cancels the debt in exchange for overtime services, the cancellation should be treated as compensation from both the employee-debtor's and the employer-creditor's perspectives. Treating the discharge as payment for services rather than DOI income results in significant differences with respect to (1) the employee's ability to take advantage of the section 108 income exclusions discussed in §§ 2.6(a)-(d), (2) the timing of the income (if the advance of money is a prepayment for services rather than a bona fide loan), and (3) the corporation's ability to deduct the amount as compensation expense as opposed to a bad debt. If the debt has depreciated in value at the time it is forgiven as compensation, it may be more appropriate to bifurcate the cancellation as compensation up to the value of the debt (which should equal the value of the services performed) and DOI income with respect to any remaining amount.

Due to the variety of financial arrangements in employment relationships, there are many ways in which something that facially resembles debt discharge is actually a payment for services. For example, employers often pay the moving expenses of an employee who generally agrees to repay those expenses if the

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[30] Treas. Reg. § 1.301-1(m). The distribution is treated as a dividend to the extent of the corporation's earnings and profits, then as a return of the shareholder's basis in the stock, and finally as a capital gain. I.R.C. § 301(c). *See* § 2.9(a), Example 2.13 regarding debt cancellation between members of a consolidated group.

[31] *See* Rev. Rul. 2004-79, 2004-31 I.R.B. 1. Revenue Ruling 2004-79 suggests another approach, which determines fair market value by reference to the debt's adjusted issue price under I.R.C. sections 1273 and 1274. For an analogous discussion, *see* § 2.9(a), Example 2.11.

[32] *See Combrink v. Commissioner*, 117 T.C. 82 (2001).

[33] *Nemark v. Commissioner*, 311 F.2d 913, 915 (2d Cir. 1962); *Denny v. Commissioner*, 33 B.T.A. 738 (1935); *Lehew v. Commissioner*, 54 T.C.M. (CCH) 81 (1987); Treas. Reg. § 1.61-12(a).

employee quits within a certain time frame. If the employee does quit, the employer may cancel the reimbursement obligation. In a Private Letter Ruling,[34] the IRS determined that the cancelled obligation must be reported as income on a W-2 (i.e., as wages) because the indebtedness arose as a result of an employment relationship.

Another example of compensation resulting from debt discharge arises when an employer transfers property to an employee in exchange for a note, which is later reduced or cancelled. Generally, the amount of compensation the employee includes in gross income is the excess of the fair market value of the property over the amount (if any) paid for the property. Debt may be treated as an amount paid for the property, thereby lowering the amount the employee includes in gross income. The forgiveness or cancellation of that debt, in whole or part, will be included in the gross income of the employee as compensation rather than DOI income.[35]

(v) No Income

I.R.C. section 108(f) provides a special rule for the cancellation of student debt. The gross income of an individual does not include DOI income attributable to the forgiveness of certain student loans. I.R.C. section 108(f) excludes something from gross income that would otherwise be DOI income; there are several other situations where a discharge of debt does not result in income from the start.

A cancellation of debt may result in no income if the discharge is a gift.[36] This is fairly easy to envision among family members or individuals with personal relationships. The issue that has created more confusion is whether a cancellation of debt may be treated as a gift in a commercial context. The Supreme Court originally held that a commercial discharge was a gift in *Helvering v. American Dental Co.*,[37] but later in *Commissioner v. Jacobson*,[38] the Supreme Court held that a commercial discharge was not a gift and resulted in DOI income. Uncertainty remained because the *Jacobson* decision did not overrule *American Dental*. Congress resolved this issue in the legislative history to the Bankruptcy Tax Act of 1980, which provides that gifts do not occur in a commercial context.[39]

A guarantor does not realize income when the primary debtor makes a payment or satisfies the debt. In *Landreth v. Commissioner*,[40] the Tax Court held that a guarantor does not realize DOI income when the principal debtor discharges the debt. In reaching this conclusion, the Tax Court contrasted the impact of a cancellation of debt on a primary debtor with the impact on a guarantor. If the obli-

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[34] Private Letter Ruling 8315021 (Jan. 7, 1983).

[35] Treas. Reg. §§ 1.83-1(a)(1), -4(c).

[36] The issue of valuation and the bifurcated treatment discussed in § 2.3(a)(iv) could similarly arise in the gift context. For instance, assume a debt from a son to his mother in the amount of $100 has depreciated in value to $85 due to interest rate fluctuations. If mother discharges the indebtedness, one approach would be to treat $85 as a gift and $15 as DOI income. *See* I.R.C. § 102.

[37] 318 U.S. 322 (1943).

[38] 336 U.S. 28 (1949).

[39] S. Rep. No. 1035, 96th Cong. 2d Sess. 19 n. 22 (1980).

[40] 50 T.C. 803 (1968), *acq.*, 1969-2 xxiv.

gation of a debtor is relieved, the debtor's net worth increases and the debtor may have DOI income under *Kirby Lumber*.[41] However, when a guarantor is relieved of the contingent liability, either because of payment by the debtor or a release given by the creditor, there is no accretion of assets.[42] The payment by the debtor did not result in an increase in the guarantor's net worth, it merely prevented a decrease in the guarantor's worth. The Tax Court concluded that the "guarantor no more realizes income from the transaction than he would have if a tornado, bearing down on his home and threatening a loss, changes course and leaves the house intact."[43]

(vi) Contested Liability Doctrine and Unenforceable Debt

Under the contested liability doctrine, a taxpayer who disputes the original amount of a debt and later settles with the creditor on a lesser figure can use the lower amount when computing DOI income. That is, the excess of the original debt over the amount later determined to be correct may be disregarded in calculating gross income.[44] Situations that invoke the contested liability doctrine often involve debt that may not be enforceable, which invokes another rule: if there is no legal obligation to pay the debt, there is no income when that "debt" is discharged.

The Third Circuit considered the contested liability doctrine and unenforceable debt in *Zarin v. Commissioner*.[45] This case involves a $3.4 million gambling debt that arose when Mr. Zarin borrowed gambling chips from a casino. He immediately lost the chips and eventually settled the matter with the casino for $500,000. The Tax Court held that Mr. Zarin realized DOI income in an amount equal to the difference between the amount borrowed and the amount paid. The Third Circuit reversed on two grounds. The first and more compelling reason was that Mr. Zarin did not have a legal liability to the casino. Applicable law prohibited the casino from providing a marker to Mr. Zarin in the amount that it did, so he was not legally obligated to satisfy the debt. The gambling debt did not meet the definition of indebtedness in I.R.C. section 108(d)(1), so its discharge was not income under I.R.C. section 61(a)(12).[46] The second reason was application of the contested liability doctrine. The casino and Mr. Zarin settled the unenforceable debt for $500,000, which Mr. Zarin paid. Because Mr. Zarin

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[41] 284 U.S. 1 (1931).

[42] 50 T.C. at 813, *citing Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932) and *Fashion Park, Inc. v. Commissioner*, 21 T.C. 600 (1954).

[43] 50 T.C. at 813. Case law addresses this concept in other situations. *See Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956); *Eagle Asbestos & Packing Co. v. United States*, 348 F.2d 528 (Ct. Cl. 1965); Yale Avenue Corp. v. Commissioner, 58 T.C. 1062 (1972).

[44] *Preslar v. Commissioner*, 167 F.3d 1323, 1327 (10th Cir. 1999). *See, e.g.*, Private Letter Ruling 200243034 (July 26, 2002) (no DOI income from the discharge of unliquidated tort and environmental claims).

[45] 916 F.2d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989).

[46] *See also Vanguard Recording Society v. Commissioner*, 418 F.2d 829 (2d Cir. 1969) (taxpayer debited accounts payable and credited an earned surplus account to dispose of an ancient, unexplained control account; this did not result in DOI income because there was no evidence of an underlying debt).

owed and paid the same amount, there was no DOI income. The authors do not find much comfort or basis in this rationale.

The Third Circuit's holding in *Zarin* has been questioned by other courts. In *Preslar v. Commissioner*,[47] the Tenth Circuit found that the Third Circuit improperly applied the contested liability doctrine to unenforceable debt, confusing liquidated debt with unliquidated debt. According to the Tenth Circuit, the contested liability doctrine only applies to unliquidated debt, that is, the theory applies when the exact amount of consideration that initially exchanged hands is unclear.[48] A total denial of liability or a challenge to the enforceability of the underlying debt does not go to the amount of the underlying debt. The Tenth Circuit found that in such a situation, the infirmity exception to the purchase price adjustment rule (which is discussed in § 2.5(b)) would apply, but the contested liability doctrine would not.

At least one court sidestepped the contested liability doctrine by resorting to the tax benefit rule. In *Schlifke v. Commissioner*,[49] the Tax Court avoided the necessity of cutting its "way through the thicket of subissues . . . such as the presence of a liquidated, as distinguished from an unliquidated indebtedness, and the enforceability of the underlying obligation, i.e., whether it is void or voidable and the impact of the element of rescission. . . ."[50] by applying the tax benefit rule. To simplify the facts of the case, Republic Home Loan (Republic) loaned $100 to the Schlifkes, who paid $20 in interest on the loan and deducted $20 as interest expense. The Schlifkes rescinded the loan three years later because it violated the Truth in Lending Act. As part of the rescission, the previously paid $20 in interest was applied against the $100 principal of the loan, reducing the Schlifkes debt to $80.

The Tax Court adroitly avoided DOI income issues by applying the tax benefit rule. Under the tax benefit rule, if an amount deducted from gross income in one tax year is recovered in a subsequent tax year, the recovery is included in gross income in the year of receipt, to the extent the prior deduction resulted in a tax benefit.[51] The Tax Court held that under the tax benefit rule the Schlifkes had taxable income of $20. The court cited and quoted *Hillsboro National Bank v. Commissioner* for the proposition that the tax benefit rule triggers income where a "subsequent recovery . . . would be fundamentally inconsistent with the provision granting the deduction."[52]

The Tax Court's ultimate holding in *Schlifke* may be correct, namely that the taxpayers should include income. The outcome is consistent with the Supreme Court's later decision in *Centennial Savings*. The Tax Court in *Schlifke*, however, could have concluded that there was no discharge of indebtedness under *Zarin*, because the taxpayer fulfilled its legal liability under the terms of the note and

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[47] 167 F.3d 1323, 1327-29 (10th Cir. 1999).

[48] *See Earnshaw v. Commissioner*, 84 T.C.M. (CCH) 146 (2002) (applying *Preslar* holding that the contested liability doctrine does not apply to liquidated debt and finding that credit card finance charges and late payment fees do not create a liquidated debt).

[49] 61 T.C.M. (CCH) 1697 (1991).

[50] *Id.* at 1698.

[51] *See* § 2.6(e) for a discussion of the tax benefit rule.

[52] *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 384 (1983).

applicable law. We will never know. The Tax Court's short shrift approach, completely discarding the characterization of the income as discharge of indebtedness, is not a recommended analysis. Although the characterization of the income may not have made a difference under the facts of the case, it could easily have significant implications if the debtor were in bankruptcy or insolvent.

(b) Is the Obligation Indebtedness?

Another threshold issue is whether the obligation is "indebtedness" for federal income tax purposes. If the instrument is not "indebtedness," then the I.R.C. section 108 rules do not apply. For closely held corporations, the nature of an instrument as debt or equity may be questioned. In general, debt qualifies as indebtedness for federal income tax purposes, in part, if the amount of the obligation does not exceed the amount that a reasonable unrelated lender would lend to the debtor under commercially reasonable terms.[53]

(c) Who Is the Debtor?

If there are multiple debtors liable for a debt that is cancelled, any DOI income must somehow be allocated among the debtors. Stated another way, who is the debtor for federal income tax purposes? In a Private Letter Ruling,[54] a partnership owned an insolvent corporation and both were jointly and severally liable on bank debt. As part of a settlement with the bank, the partnership satisfied the debt for less than the amount due. The IRS found that the corporation (not the partnership) recognized DOI income, which was excluded to the extent of its insolvency.

Another case involving the identity of the debtor is *Plantation Patterns, Inc. v. Commissioner*.[55] A corporation issued debentures that were personally guaranteed by its sole shareholder.[56] Even though the corporation made all payments due on the debentures, the Fifth Circuit considered the circumstances that

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[53] The criteria by which to judge the nature of an instrument follow: (1) intent of the parties; (2) identity between creditors and shareholders; (3) extent of participation in management by the holder of the instrument; (4) ability of the corporation to obtain funds from outside sources; (5) "thinness" of the capital structure in relation to debt; (6) risk; (7) formalities; (8) relative position of the obligees as to other creditors; (9) voting power of the holder; (10) fixed rate of interest; (11) contingency on the repayment obligation; (12) source of interest payments; (13) fixed maturity date; (14) provision for redemption by the corporation; (15) provision for redemption at the option of the holder; and (16) timing of the advance with reference to the organization of the corporation. *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968).

[54] Private Letter Ruling 9317020 (Jan. 27, 1993). *See also* Private Letter Ruling 9105042 (Feb. 27, 1990).

[55] 462 F.2d 712 (5th Cir. 1972), *aff'g* 29 T.C.M. (CCH) 817 (1970).

[56] This is a simplification of the facts. The *Plantation Patterns* fact pattern is more complicated—wife was the sole shareholder of the corporation and her husband guaranteed the debentures. The court found that husband completely controlled the wife's stock and held that the husband was the constructive owner of the stock. *Plantation Patterns*, 462 F.2d at 722.

existed when the debentures were issued and held that the debentures were not indebtedness of the corporation. Thus, the corporation was not a debtor and not entitled to deduct the payments made on the debentures as an interest expense. Rather, the Fifth Circuit treated the debentures as a contribution of capital by the shareholder and treated the corporation's payments as distributions to the shareholder.[57]

The authors have often seen practitioners express undue concern regarding a *Plantation Patterns* issue. Every shareholder guarantee of a corporation's debt does not result in this treatment. Even if a lending institution would lend money to a corporation on a stand-alone basis, those institutions commonly require a shareholder guarantee when the corporation is closely held. Under these circumstances, the corporation's obligation should be treated as indebtedness and not recast under *Plantation Patterns*.

(d) When Does Discharge of Indebtedness Income Occur?

Sometimes the issue is not whether DOI income exists, but when it occurs. Debt is discharged when it becomes clear that the debt will never have to be paid, based on a practical assessment of the facts and circumstances.[58] The courts require only that the time of discharge be fixed by an identifiable event. Repayment of the loan need not become absolutely impossible before a debt is considered discharged. A slim possibility of repayment does not prevent a debt from being treated as discharged. Whether a debt has been discharged depends on the substance of the transaction. The courts look beyond formalisms, such as the surrender of a note or the failure to do so.[59]

Corduan v. Commissioner[60] not only provides another example of what is income from debt cancellation, but also sheds some light on when that income is realized. The taxpayer owned a piece of equipment subject to recourse debt of $18,581. The creditor repossessed the equipment, which had a fair market value of $12,575. The taxpayer and the creditor later agreed that the taxpayer would pay the creditor $1,000 and the creditor would release the taxpayer from the remaining debt. Debt is considered discharged "the moment it is clear that it will not be repaid." Using this standard, the Tax Court held that the taxpayer had DOI income of $5,006 ($18,581 less $12,575 less $1,000) when the creditor released the taxpayer from further obligations under the debt, not when the creditor repossessed the equipment.

In *Milenbach v. Commissioner*,[61] the Ninth Circuit considered the timing of DOI income. The taxpayer owned the Los Angeles Raiders and the case arose from the nomadic nature of the team. In 1987, the Raiders tried to move from

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[57] The cancellation of a debt may be a corporate distribution. *See* § 2.3(a)(iv).

[58] For other cases addressing the timing of DOI income *see United States v. Ingalls*, 399 F.2d 143 (5th Cir. 1968); *Estate of Broadhead v. Commissioner*, 391 F.2d 841 (5th Cir. 1968); Estate of Shapiro v. Commissioner, 53 T.C.M. (CCH) 317 (1987). *See also* Significant Service Center Advice 200235030 (June 3, 2002).

[59] *Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987).

[60] T.C. Summary Opinion 2001-74 (2001).

[61] 318 F.3d 924 (9th Cir. 2003), *rev'g in part, aff'g in part, and remanding*, 106 T.C. 184 (1996).

Los Angeles to Irwindale, California. In connection with the move, the Raiders executed a Memorandum of Agreement (MOA) with the city of Irwindale for a $115 million loan to finance a football stadium. Irwindale advanced the Raiders $10 million of the $115 million. The MOA provided that, if Irwindale failed to perform its obligations, the Raiders' obligations would be extinguished, including the obligation to repay the advance. The Raiders would be allowed to keep the advanced funds "as consideration for the execution" of the MOA. The MOA stated that Irwindale proposed to finance the stadium by issuing general obligation bonds. In 1988, the California legislature passed a statute that precluded the use of general obligation bonds to build a stadium. Despite this legislation, the Raiders continued to negotiate with the city through 1990 to construct a stadium in Irwindale. All alternative financing schemes were rejected, however. The Raiders never repaid the $10 million advance.

The classification of the $10 million as DOI income was not in dispute in *Milenbach*.[62] The timing of the DOI income was the issue. The Tax Court held that the Irwindale debt was discharged in 1988, primarily because the 1988 legislation made financing the stadium with general obligation bonds impossible. The Ninth Circuit disagreed, finding that although the parties assumed that Irwindale would fund the loan with these general obligation bonds, that funding was not required by the MOA. Forfeiture would occur only if Irwindale was unable to provide the funds, from whatever source. The passage of the 1988 legislation was simply an obstacle that the Raiders and Irwindale attempted to overcome. The Ninth Circuit remanded the matter to the Tax Court to determine when the Irwindale debt was discharged, directing the Tax Court to perform a "practical assessment of the facts and circumstances relating to the likelihood of payment" to determine when, as a practical matter, it became clear that Irwindale would not be able to fund the entire loan and that the stadium would not be built.

§ 2.4 SECTION 108(e) ADDITIONS TO DISCHARGE OF INDEBTEDNESS INCOME

(a) Debt Acquired by Related Party: Section 108(e)(4)

As discussed in § 2.3(a)(iii), a debtor may have DOI income when it repurchases its own debt for less than the adjusted issue price.[63] A debtor cannot avoid the DOI income by inducing a related party to purchase the debt at a discount because I.R.C. section 108(e)(4) recharacterizes the purchase by the related party as a purchase by the debtor.

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[62] Applying the *Centennial Savings* principles (*see* § 2.3(a)(i)) to the $10 million advance seems to show the Ninth Circuit missed the mark because the Raiders did not have DOI income. Irwindale did not forgive an obligation that the Raiders incurred at the outset of the debtor-creditor relationship. Because repayment of the $10 million advance was not required under the terms of the MOA, there was no release of an obligation to repay. The Raiders did have income as a result of the advance, but that income does not appear to be DOI income.

[63] Treas. Reg. § 1.61-12(c)(2)(ii).

(i) Related Party

I.R.C. section 108(e)(4) identifies a "related party" by cross-reference to the relationships in I.R.C. sections 267(b) and 707(b)(1), which include family members, shareholders and controlled corporations, fiduciaries and beneficiaries of a trust, and many others. For example, a person is considered related to the debtor if that person is:

- A member of a controlled group (for purposes of I.R.C. section 414(b)) of which the debtor is also a member;
- Under common control with the debtor as defined in I.R.C. section 414(b) or (c);
- A partner in a partnership that the debtor controls (owns more than 50 percent of the capital interest or profit interest);
- A partner in a partnership that is under common control as defined in I.R.C. section 707(b)(1).

The Bankruptcy Tax Act does provide for some exceptions to the related party rules. As one example, brothers and sisters of the debtor are not related parties. Other family members—the debtor's spouse, children, grandchildren, parents, and any spouse of the debtor's children or grandchildren are related parties.[64]

(ii) Acquisition by a Related Party

Under I.R.C. section 108(e)(4), the acquisition of the debt of a related party from a person who is not a related party can result in DOI income to the debtor (a "direct acquisition"). Thus, if a parent corporation (P) purchases the debt of its subsidiary (S) on the open market, for an amount less than the adjusted issue price, there is DOI income to S. The tax consequences may be the same if the steps are reversed, that is, S acquires the debt of P in the open market at a time when S and P are unrelated, but, at a future date, P purchases the stock of S (an "indirect acquisition").

(A) Direct Acquisition

The current regulations, Treas. Reg. section 1.108-2, cover both direct and indirect acquisitions. A direct acquisition is defined as an acquisition of outstanding debt if a person related to the debtor (or a person who becomes related to the debtor on the date the debt is acquired) acquires the debt from a person who is not related to the debtor. Thus, if P owns all the stock of S, P's acquisition of S's debt, or vice versa, is a direct acquisition. Likewise, if on the same day P acquires all the stock of S from unrelated X and P acquires all the S debt from unrelated Y, there is a direct acquisition within the meaning of I.R.C. section 108(e)(4) and S has DOI income.

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[64] *See, e.g.*, Technical Advice Memorandum 9541006 (July 5, 1995) (two S corporations, S1 and S2, are owned, respectively, by husband and wife; debt of S1 acquired at a discount from bank by S2; pursuant to I.R.C. section 108(e)(4), S1 has DOI income).

The IRS is studying transactions in which P acquires the S stock and the S debt from the same person in the same transaction, to see whether these transactions should be excluded from the definition of a direct acquisition.[65]

(B) Indirect Acquisition

Indirect acquisitions, which fall outside the literal language of I.R.C. section 108(e)(4), achieve the same result as direct acquisitions. In response to these indirect acquisitions and to prevent abuses under I.R.C. section 108(e)(4), the government issued regulations, at Treas. Reg. section 1.108-2.[66] Under the current regulations, an indirect acquisition is a transaction in which a holder of the debt becomes related to the debtor, if the holder acquired the debt in anticipation of becoming related to the debtor. Assume P and S are unrelated to each other. P has outstanding debt in the hands of unrelated parties. S buys the P debt in anticipation of P's acquisition of the stock of S. Shortly thereafter, P buys all the stock of S. The discharge of indebtedness rules and I.R.C. section 108(e)(4) apply. Similarly, if S had outstanding debt held by unrelated parties, the acquisition by P of the S debt in anticipation of P's buying the S stock is also an indirect acquisition.

The contentious phrase in the definition of an indirect acquisition is "in anticipation of becoming related." A holder of the debt is treated as having acquired that debt in anticipation of becoming related if the relationship is established within 6 months after the debt is acquired. This appears to be a conclusive presumption. If the relationship is not established within 6 months, "all facts and circumstances will be considered . . . including the intent of the parties." Specifically, the nature of the contacts between the parties, the time period during which the holder held the debt, and the significance of the debt in proportion to the total assets of the holder (or holder group)[67] are considered. Curiously, the absence of discussions between the debtor and the holder does not, by itself,

[65] T.D. 8460, 57 Fed. Reg. 61805 (Dec. 29, 1992) (preamble).

[66] I.R.C. section 108(e)(4) provides that "regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness. . . ." Although I.R.C. section 108(e)(4) is generally applicable to transactions after December 31, 1980 and the rules of Treas. Reg. section 1.108-2 are applicable over 10 years later, to transactions after March 21, 1991, the statutory language could be interpreted as creating self-executing regulations. That is, the treatment is available whether or not the government issues regulations. Additionally, before the regulations were issued, a successful step transaction doctrine argument could apply the related party rule to some indirect acquisitions of debt and stock (e.g., that took place on the same day or pursuant to the same commitment); but the result would have been unclear for other indirect acquisitions (e.g., if the two steps were stretched out over a significant period of time). *See, e.g.*, Rev. Rul. 91-47, 1991-2 C.B. 16 (applying step transaction doctrine to recast transaction where there was no business purpose and the primary purpose for the transaction was the avoidance of DOI income). *See also* Lipton, Stephens, & Freeman, Regs. Increase Gain Potential if Related Party Acquires Debt, 74 *J. Tax'n* 354 (1991).

[67] The holder group consists of the holder and all persons who are both related to the holder before the holder becomes related to the debtor and are related to the debtor after the holder becomes related to the debtor. Treas. Reg. § 1.108-2(c)(5).

establish that the holder did not acquire the indebtedness in anticipation of becoming related to the debtor.

(1) Nonrecognition Transactions and DOI Income The Treasury Department may issue regulations aimed at preventing taxpayers from using nonrecognition transactions to avoid DOI income under I.R.C. section 108(e)(4). In the preamble to the proposed Treas. Reg. section 1.108-2 regulations, the Treasury Department stated that it intended to prevent elimination of DOI income in certain nonrecognition transactions described in I.R.C. sections 332, 351, 368, 721, and 731. The preamble also provides:

> In general, if assets are transferred in a tax-free transaction and the transferee receives the assets with a carryover (or, in certain cases, a substituted) basis, any built-in income or gain is taxed when the transferee disposes of the asset. If, however, the debtor acquires its own indebtedness, the indebtedness is extinguished. In that case, the indebtedness in all cases should be treated as if it is acquired by the transferee and then satisfied. Similar treatment should apply if a creditor assumes a debtor's obligation to the creditor.
>
> In both cases, the debt is effectively extinguished, and current recognition of income from discharge of indebtedness is appropriate. Thus, the regulations to be issued will provide for recognition of income from discharge of indebtedness in these cases.[68]

Although nonrecognition transaction regulations have not been issued, the regulations, when issued, would apply retroactively to March 21, 1991.[69] Nonrecognition transactions involving the discharge of indebtedness should be evaluated to determine the possible retroactive application of these yet-to-be-issued regulations.

(2) Disclosure of Indirect Acquisition In an indirect acquisition transaction, the debtor is required to disclose, by attaching a statement[70] to its tax return for the year in which the debtor became related to the holder, whether either of two tests is met: (1) the 25-percent test or (2) the 6 to 24 month test.

The 25-percent test is satisfied if, on the date the debtor becomes related to the holder, the debt in the hands of the holder represents more than 25 percent of the fair market value of the assets of the holder (or holder group).[71] For this computation, cash, marketable stock and securities, short-term debt, options, futures contracts, and an ownership interest of a member of the group are excluded.

The 6 to 24 month test is satisfied if the holder acquired the indebtedness less than 24 months, but at least 6 months, before the date the holder becomes related to the debtor.[72]

The only exception to the disclosure requirement is where the holder actually treats the transaction as a related-party acquisition under I.R.C. section

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[68] 56 Fed. Reg. 12135 (March 22, 1991) (preamble).
[69] Notice 91-15, 1991-1 C.B. 319.
[70] The form of the attachment is identified in Treas. Reg. section 1.108-2(c)(4)(iv).
[71] Treas. Reg. § 1.108-2(c)(4)(ii).
[72] Treas. Reg. § 1.108-2(c)(4)(iii).

108(e)(4).[73] If the debtor fails to disclose, there is a rebuttable presumption that the holder acquired the debt in anticipation of becoming related to the debtor.[74]

(iii) DOI Income for a Related Party Acquisition

Two things happen if either a direct or indirect acquisition occurs. First, on the acquisition date, the debtor has DOI income measured by the difference between the adjusted issue price of the debt and the related party's basis in the debt acquired (cost). The measure is fair market value, not cost, if the holder did not acquire the debt by purchase on or less than 6 months before the acquisition (i.e., becoming related).[75] Second, the debtor is deemed to issue a new debt to the holder in an amount equal to the amount used to compute discharge of indebtedness (cost or value).[76]

As an example, holder H acquires debtor D's $1,000 face debt in the open market for $700. Five months later, H and D become related. D has DOI income of $300. D is deemed to issue a new debt to H (face $1,000 and issue price $700). Thus, H has original-issue discount deductions and H has original-issue income of $300 over the life of the old (deemed new) debt.

I.R.C. Section 108(e)(4) does not apply to all related party acquisitions of debt. For example, DOI income is not triggered if (1) the debt that is acquired in a direct or indirect acquisition has a stated maturity date within one year of the acquisition date and the debt is in fact retired on or before such date, or if (2) the acquisition of indebtedness is by certain securities dealers in the ordinary course of business.[77]

As a practical matter, many related party issues are covered by the consolidated tax return regulations. The application of section 108(e)(4) may be trumped by the application of the consolidated return regulations when a member of a consolidated group has its debt cancelled or is deemed to have its debt discharged.[78]

(b) Indebtedness Contributed to Capital: Section 108(e)(6)

Even if the cancellation of a debt is structured as an otherwise tax-free contribution to capital, DOI income may be realized under I.R.C. section 108(e)(6). The tax effect of the cancellation of a loan from a corporation to its debtor-shareholder was discussed in § 2.3(a)(iv). The opposite scenario is addressed here—the shareholder's cancellation or satisfaction of a corporation's obligation. This situation often occurs in the consolidated group setting, where different rules, which are discussed in § 2.9(a), apply.[79] Unlike the stock-for-debt exception

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[73] Treas. Reg. § 1.108-2(c)(4)(i).
[74] Treas. Reg. § 1.108-2(c)(4)(v).
[75] Treas. Reg. § 1.108-2(f).
[76] *See* Rev. Rul. 2004-79, 2004-31 I.R.B. 1 (analyzing a direct related-party acquisition under I.R.C. section 108(e)(4)).
[77] *See* Treas. Reg. § 1.108-2(e).
[78] For a discussion of the consolidated tax return regulations see § 2.9(a).
[79] *See* § 2.9(a), Examples 2.12 and 2.13 regarding the cancellation of a subsidiary's debt by its parent corporation in the consolidated group context.

under I.R.C. section 108(e)(8) discussed in § 2.4(c), the capital-contribution situation generally involves a creditor who is an existing shareholder of the debtor corporation. Nevertheless, the capital-contribution exception and the stock-for-debt exception are similar enough to overlap in many situations, as discussed in §2.4(c)(ii).

I.R.C. section 108(e)(6) provides that if a debtor corporation acquires its debt from a shareholder as a contribution to capital, I.R.C. section 118 (which excludes contributions to capital from the corporation's gross income) does not apply and the corporation will be deemed to have satisfied the debt with an amount of money equal to the shareholder's adjusted basis in the debt.

The satisfaction of a debt in exchange for stock of the debtor corporation is not considered a contribution to capital, however, if the shareholder is also a creditor and acts as a creditor to maximize the satisfaction of a claim.[80] This exception might apply to situations where stock and bonds are publicly held and the creditor also happens to be a shareholder.

Shareholders who forgive corporate debt would prefer a bad debt deduction to capital contribution treatment. The shareholder was allowed a bad debt deduction rather than capital contribution treatment in *Mayo v. Commissioner*.[81] The shareholder in *Mayo* forgave debt of an insolvent corporation, but the corporation was still "hopelessly insolvent, even after the cancellation." Thus, the Tax Court held that the cancellation of debt of the insolvent corporation did not enhance the corporation's value and, therefore, did not constitute a contribution to capital.[82]

Lidgerwood Mfg. Co. v. Commissioner,[83] unlike *Mayo*, found that the shareholder made a capital contribution in the form of debt forgiveness. The Second Circuit assumed that the debtor corporation was insolvent both before and after the cancellation; however, there was no finding that the corporate debtor was "hopelessly insolvent." The Second Circuit noted that:

> [W]iping out the debts was a valuable contribution to the financial structure of the subsidiaries. It enabled them to obtain bank loans, to continue in business and subsequently to prosper. This was the avowed purpose of the cancellations. Where a parent corporation voluntarily cancels a debt owed by its subsidiary in order to improve the latter's financial position so that it may continue in business, we entertain no doubt that the cancellation should be held a capital contribution and preclude the parent from claiming it as a bad debt deduction.[84]

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[80] S. Rep. No. 1035 96th Cong., 2d Sess. 19, n. 22 (1980).

[81] T.C. Memo 1957-9, 16 T.C.M. (CCH) 49 (1957) (treating the bad debt deduction as a nonbusiness bad debt deduction).

[82] *Cf. Giblin v. Commissioner*, 227 F.2d 692 (5th Cir. 1955) (holding that, under similar facts, cancellation of a debt to a corporation that was insolvent both before and after the cancellation was not a contribution to capital).

[83] 229 F.2d 241 (2d Cir. 1956), *aff'g* 22 T.C. 1152 (1954). *Lidgerwood* and *Mayo* were both decided before I.R.C. section 108(e)(6) was enacted.

[84] *Lidgerwood* at p. 243. The Second Circuit cited *Bratton v. Commissioner*, 217 F.2d 486 (6th Cir. 1954) to support its holding, but distinguished and disagreed with Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955) (discussed *supra* note 82).

In addition to *Lidgerwood*, the bulk of case law favors characterizing a shareholder's cancellation of debt of an insolvent corporation as a contribution to capital, rather than allowing the shareholder a bad debt deduction.[85]

A 1998 Field Service Advice[86] cites to *Mayo* and *Lidgerwood*, while considering the tax treatment when a parent corporation (P) forgives debt of a wholly owned, and insolvent, subsidiary (S). To illustrate the determination in the Field Service Advice, assume S is insolvent to the extent of $10 and P forgives a note with a face amount of $20, in which S has a basis of $20.

Turning first to whether P (the shareholder) made a capital contribution, the IRS applied the following standard: "A shareholder generally makes a capital contribution to a debtor corporation to the extent that the shareholder's cancellation of the corporation's debt enhances the value of the shareholder's stock." The value of the stock of S, the debtor corporation, increased by the amount by which it became solvent as a result of the debt cancellation. Applying this standard to the numbers above, the value of S stock increased from zero to $10. Under I.R.C. section 108(e)(6), S is deemed to have satisfied $10 of the outstanding debt with an amount equal to P's $10 basis in that portion of the debt. Under the assumed facts, S would not have DOI income on the portion that qualified as a capital contribution, but if P had a lower basis in the debt, then S could have DOI income.

Recall that only $10 of the $20 of debt cancellation is treated as a capital contribution. The IRS found that S realized DOI income equal to the cancelled debt that is not a capital contribution.[87] Special rules that apply when an insolvent taxpayer has DOI income are discussed in § 2.6(b). Under those rules, S has all the DOI income excluded from income under the I.R.C. section 108(a)(1)(B) insolvency exclusion (i.e., to the extent of its insolvency of $10) and applied to reduce tax attributes pursuant to I.R.C. section 108(b)(1).

(i) Allocation between Principal and Interest

Allocation between principal and interest is another matter to be considered with regard to the deemed satisfaction of an outstanding debt under section 108(e)(6). If a corporation is deemed to satisfy outstanding debt (attributable to principal or loaned funds and to accrued but unpaid interest) the payment must be allocated between principal and interest. Prior law allowed the parties to

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[85] *See, e.g., Plante v. Commissioner*, 168 F.3d 1279 (11th Cir. 1999); *Bratton v. Commissioner*, 217 F.2d 486 (6th Cir. 1954). *See also Carroll-McCreary v. Commissioner*, 124 F.2d 303 (2d Cir. 1941) (holding that debt discharge, which made an insolvent corporation solvent, was a capital contribution, not DOI income); *Hartland Assoc. v. Commissioner*, 54 T.C. 1580 (1970), *nonacq.*, 1976-2 C.B. 3 (holding that taxpayer was not entitled to a bad debt deduction, rather discharge was a capital contribution to a corporation in a poor financial position that continued to worsen (unclear whether the corporation was insolvent)).

[86] Field Service Advice 199915005 (Dec. 17, 1998).

[87] *But see Carroll-McCreary*, 124 F.2d 303, which comes to the opposite conclusion and treats the full amount of the discharge as a capital contribution when the discharge caused the corporation to become solvent.

decide how to allocate the payment.[88] Under current law, the payment is generally first allocated to the interest component.[89]

(ii) Withholding Requirement

The IRS took the fiction of the deemed allocation one step further in a Field Service Advice by requiring withholding for a foreign creditor who had a deemed payment of interest under I.R.C. section 108(e)(6).[90] This conclusion is questionable in light of the introductory language of I.R.C. section 108(e)(6), which provides that it is "for purposes of determining income of the debtor from discharge of indebtedness. . . ." The IRS's position in the Field Service Advice applies the deemed payment treatment to other purposes of the I.R.C. Extending this logic one more step, the deemed interest payment could result in an interest deduction and interest income for cash-method debtors and creditors.

(iii) Accounting Method Differences

The effect of I.R.C. section 108(e)(6) may rectify complications caused by different accounting methods of the corporation and the shareholder, as illustrated by the following example. Assume that a cash-method shareholder lends $1,000 to an accrual-method corporation and that interest in the amount of $200 accrues on the loan, but is not paid by the corporation.[91] This results in a $200 interest expense deduction to the accrual-method corporation, but no interest income to the cash-method shareholder. If the shareholder cancels the debt as a contribution to capital, the corporation is no longer obligated to pay $1,200. Under section 108(e)(6) the corporation is deemed to satisfy the $1200 obligation with an amount equal to the shareholder's basis in the debt of $1,000. This means that the corporation would have DOI income of $200.[92] The deemed $1,000 payment is split between $200 on the $200 accrued interest and $800 on the $1,000 of principle.

(c) Stock for Debt: Section 108(e)(8)

A debtor corporation may have DOI income if its debt is transferred to the corporation from a shareholder. Similarly, if the debt is transferred to the corporation in exchange for the corporation's stock (making the creditor a shareholder), the debtor corporation has DOI income under I.R.C. section 108(e)(8) to the

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[88] *See, e.g.*, Huntington-Redondo Co. v. Commissioner, 36 B.T.A. 116 (1937); Rev. Rul. 63-57, 1963-1 C.B. 103.

[89] Treas. Reg. § 1.446-2.

[90] 1993 FSA LEXIS 102 (Mar. 5, 1993).

[91] For purposes of simplicity, it is assumed that the original issue discount provisions of the I.R.C do not cover the debt instrument. If those provisions apply, a cash-method taxpayer may be required to include in income the original issue discount as it accrues, which would be reflected in the creditor's basis in the debt. *See generally* I.R.C. §§ 1271-1274 and accompanying regulations.

[92] I.R.C. § 108(e)(6) overruled *Putoma Corp. v. Commissioner*, 601 F.2d 734 (5th Cir. 1979) which would have treated the entire $1,200 as a tax-free contribution of capital. The discharge would also not be excluded under I.R.C. section 108(e)(2), which is discussed in § 2.5(a), because the *payment* of the interest by an accrual-method corporation would not result in a deduction to such corporation.

extent, if any, that the amount of the debt discharged exceeds the fair market value of the stock issued.

(i) Background

For many years, a corporation that satisfied debt with stock could take advantage of a favorable nonrecognition rule. That rule, however, eventually evolved into a recognition rule. The courts initially held that the exchange of stock for debt does not require the recognition of income. This nonrecognition rule was known as the stock-for-debt exception. The stock-for-debt exception, as originally codified, applied to solvent corporations as well as insolvent corporations and those in bankruptcy proceedings.[93] The Tax Reform Act of 1984 changed this by providing for a general recognition rule for stock-for-debt exchanges, and an exception to that general recognition rule for insolvent debtors and debtors in title 11 cases.[94] The Omnibus Budget Reconciliation Act of 1993 abolished that regime by eliminating the exception for insolvent and title 11 debtors, leaving only the general recognition rule in place. Income recognized under this provision will continue to be excludable under section 108(a) for insolvent and title 11 debtors, but only at the price of attribute reduction.[95]

(ii) Overlap with Capital-Contribution Rule

Depending on the facts, the difference between an I.R.C. section 108(e)(6) capital contribution and an I.R.C. section 108(e)(8) stock-for-debt exchange may merely be a matter of form or may have economic significance. In this situation, which rule should govern? There are three possibilities: (1) form governs, (2) the stock-for-debt rule trumps, or (3) the capital-contribution rule trumps. The answer may have significant tax implications.

Suppose a corporation has two 50-percent shareholders (A and B) and the corporation also has an outstanding debt to A. The satisfaction of the debt by means of a stock-for-debt exchange would change the relative ownership percentages in the corporation, an economically significant event. If shareholder A receives additional stock in satisfaction of the debt, A's percentage of the ownership increases and B's decreases. However, if A merely discharges the corporation's debt by means of a capital contribution, the relative stock ownership percentages would be unchanged. The application of the stock-for-debt rule or the capital-contribution rule is straightforward in this example, depending on whether or not A receives additional stock. Substance and form are uniform.

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[93] *Commissioner v. Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946); *Commissioner v. Capento Securities Corp.*, 140 F.2d 382 (1st Cir. 1944).

[94] For authorities and commentary under the stock-for-debt exception *see* former I.R.C. section 108(e)(10), Treas. Reg. section 1.108-1, *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943); Rev. Rul. 92-52, 1992-2 C.B. 34; Rev. Rul. 69-135, 1969-1 C.B. 198; Rev. Rul. 59-222, 1959-1 C.B. 80; Private Letter Ruling 8852039 (Oct. 4, 1988); Lipton, Debt-Equity Swap for Parent-Subsidiary: A Current Analysis of a Useful Technique, 59 *J. Tax'n* 406 (1983).

[95] *See* § 2.7(a). The repeal of the stock-for-debt exception applies to stock transferred after December 31, 1994. Later transfers will continue to be subject to the stock-for-debt exception only if they were made pursuant to title 11 or similar cases filed on or before December 31, 1993.

The distinction between the stock-for-debt and capital-contribution rules blurs if a pro rata discharge of the debt among all shareholders of a debtor corporation is considered. If the discharge is pro rata, the actual issuance of additional stock in satisfaction of the debt is mere formalism without economic significance. This concept is easily illustrated in the sole-shareholder context. Assume that A owns 100 percent of the stock in corporation X, which has a bona fide debt to A. If A discharges X's obligation, the receipt of additional shares would be economically meaningless. Whether or not additional stock is issued, the debt is discharged and A owns 100 percent of the outstanding stock of X, both before and after the discharge.

Assume Corporation Y issued a $1,000 outstanding obligation bearing a market rate of interest. The value of the obligation declines due to market fluctuations in interest and Drew, a person unrelated to Y, purchases the obligation on the market for $950. Two years later, in an unrelated transaction, Mary acquires 100 percent of the stock of Y.[96] The fair market value of the debt instrument further declines to $920. If Y satisfies the $1,000 obligation with $920 worth of its own stock, Y would realize $80 of DOI income pursuant to the stock-for-debt rule. However, pursuant to the capital-contribution rule, if Drew forgives the debt as a capital contribution, Y would realize $50 of DOI income, determined by subtracting Drew's basis in the debt ($950) from the adjusted issue price of the debt ($1,000).

The IRS considered the overlap in two private letter rulings. In a 1989 ruling,[97] form governed and the stock-for-debt rule applied. In that ruling, P, a corporation, owns all the stock and a debt instrument of subsidiary S. P surrenders the debt to S in exchange for newly issued S stock equal in value to the fair market value of the debt. Even though P is the sole shareholder of S both before and after, the IRS allowed the form to control and applied the stock-for-debt rules and not the capital-contribution rules. As a result, income to S is measured by the excess of the principal amount of the debt over the value of the stock issued, and not by the principal amount of the debt over P's basis in the debt. Assuming the adjusted issue price of the debt and the value of the S stock are equal, S would not have DOI income.

In a 1998 private letter ruling,[98] the IRS once again found that form controls and the stock-for-debt rule, and not the capital-contribution rule, applies when creditors cancel debt of a debtor corporation in exchange for debtor corporation stock. The IRS concluded that I.R.C. section 108(e)(6) did not apply because the phrase "contribution to capital" does not encompass an exchange. As a matter of form, because the debtor corporation issued stock in return for three creditors' cancellation of indebtedness, there was not a capital contribution. The IRS further concluded that the issuance of the stock could not be disregarded because the legal relationship of the creditors to the corporation changed—before the transaction, one creditor directly owned all the stock of the debtor corporation, but as a result of the transaction, the two other creditors also became sharehold-

[96] For purposes of simplicity, this example does not take into consideration the tax effects of market discount rules of I.R.C. section 1276.
[97] Private Letter Ruling 9018005 (Nov. 15, 1989) (reviewed by the Treasury).
[98] Private Letter Ruling 9830002 (Mar. 20, 1998).

ers of the corporation. Thus, because the debt cancellations were not capital contributions, I.R.C. section 108(e)(6) could not apply, and therefore, the stock-for-debt rule of I.R.C. section 108(e)(8) applied.

Do these private letter rulings mean that form always governs in an overlap? Although tax practitioners generally regard this as the better view,[99] a careful practitioner should consider the substance of the transaction and the meaningless gesture doctrine.

(A) Meaningless Gesture Doctrine

The meaningless gesture doctrine has been applied in I.R.C. section 351 exchange transactions. I.R.C. section 351 allows a taxpayer to transfer property to a controlled corporation in a tax-free exchange.[100] Both the courts and the IRS have acknowledged that when a 100-percent shareholder transfers property to the corporation in a section 351 exchange, the issuance of additional shares of stock would be a meaningless gesture[101] and the transfer of the property is tax-free regardless of whether additional shares are actually issued. If the meaningless gesture doctrine is applied in a pro rata debt discharge in which additional shares were not issued, the transaction could be evaluated as if the shares were constructively issued. This approach would require the stock-for-debt rules to apply in an overlap situation. This is in contrast to the approach of the IRS in several private letter rulings that blessed capital-contribution-rule treatment where no stock was issued.[102]

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[99] *See also* Private Letter Ruling 9010077 (Dec. 14, 1990) (issuance of preference stock to a 90.28-percent shareholder as consideration for subordinated debt is treated as stock-for-debt exchange).

[100] In general, I.R.C. section 351 requires a transfer of property to a controlled corporation solely in exchange for the controlled corporation's stock. The transferee corporation must be controlled immediately after the property transfer by the transferors. Control for this purpose means ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each class of nonvoting stock. I.R.C. § 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

[101] *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989); Rev. Rul 64-155, 1964-1 C.B. 38; Private Letter Ruling 9623028 (Mar. 7, 1996); Private Letter Ruling 9335024 (June 3, 1993); Private Letter Ruling 9215043 (Jan. 14, 1992).

[102] Private Letter Ruling 9050031 (Sept. 17, 1990) (capital-contribution rule governs the cancellation of lower-tier subsidiary's debt to common parent corporation preceding spin-off of debtor); Private Letter Ruling 8927051 (Apr. 12, 1989) (contribution of debt by two individual shareholders treated as capital contribution; the adjusted basis of each shareholder's stock interest increased by their basis in the debt); Private Letter Ruling 8844032 (Aug. 8, 1988) (the capital-contribution rule applies to the contribution of debt owed to a shareholder with a 50.01-percent direct interest and a 24.99-percent indirect interest in the debtor corporation; DOI income is the excess of the principal amount of the debt over the shareholder's adjusted basis in the debt); Private Letter Ruling 8813041 (Dec. 31, 1987) (capital-contribution rule controlled where debt of a wholly owned subsidiary is canceled by parent corporation). *See also* Private Letter Ruling 9114020 (Jan. 4, 1991) (§108(e)(6) applied in the case of brother-sister corporations where (1) S1 was indebted to S2, (2) S2 merged with S3, (3) parent contributed the stock of S1 to S3, and (4) S3 canceled the S1 note). The IRS has also punted on the issue because neither rule triggered DOI income. See Private Letter Ruling 9822005 (Jan. 16, 1998).

(B) Bifurcation

Another issue that arises in the overlap situation is whether both rules may apply to the same transaction. Although there is little authority on this question, it appears that a discharge could be bifurcated into a capital-contribution portion and a stock-for-debt portion. Consider the following scenario. Foreign Parent corporation owns 100 percent of the outstanding stock of US Subsidiary. US Subsidiary owes a $100 debt to Foreign Parent and Foreign Parent's basis in the debt and the fair market value of the debt are $100. Under foreign law, Foreign Parent cannot cancel the debt as a capital contribution without some consideration from US Subsidiary. To comply with the foreign law requirements, the US Subsidiary issues $70 of its own stock to Foreign Parent in satisfaction of the $100 debt. If the stock-for-debt rule applies, the US Subsidiary has $30 in DOI income, the difference between the outstanding debt ($100) and the fair market value of the stock issued in satisfaction of the debt ($70). This result, however, does not appear to be appropriate because the exchange is not an arm's-length transaction.

Arguably a better result—no DOI income—may be reached under two alternative theories. The route you take may depend on which camp you fell into after reading and considering the prior discussion of the stock-for-debt/capital-contribution rule overlap. If you believe the meaningless gesture doctrine applies and there should be a constructive issuance of stock, the $100 debt would be discharged in exchange for an *actual* stock issuance of $70 plus a *constructive* stock issuance of $30 resulting in no DOI income (i.e., the stock is issued in an amount equal to the fair market value of the debt). However, if you believe that form controls, there is authority (albeit outside the debt-discharge area) that a transaction may be bifurcated into a capital contribution and another type of exchange.[103] Namely, the transaction could be treated as a stock-for-debt exchange to the extent of $70 and a capital contribution of $30. This would also result in no DOI income.[104]

This issue could be avoided completely if the transaction is modified. If US Subsidiary issued $100 worth of its stock (equal to the value of the debt) or issued no stock at all (in a capital contribution or deemed stock issuance scenario), then there would be no DOI income under either the stock-for-debt rule or the capital-contribution rule. Changing the transaction to avoid the issue is preferable to issuing $70 of stock. At times, however, the form cannot be altered due to legal, accounting, or other business considerations.

(C) Advantages and Disadvantages

Whether stock-for-debt or capital contribution treatment is more advantageous is not always clear. From the debtor corporation's perspective, the amount

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[103] *See G.M. Trading Corp. v. Commissioner*, 121 F.3d 977 (5th Cir. 1997), rev'g 103 T.C. 59 (1994). This authority is controversial, in part because the IRS has continued to follow the Tax Court decision reversed by the Fifth Circuit. *See* Field Service Advice 200123008 (Feb. 27, 2001). *But see Kohler v. United States*, 247 F.Supp. 1083 (E.D. Wisc. 2003) (distinguishing *G.M. Trading Corp.*).

[104] Under the stock-for-debt rule, the $100 debt would be satisfied with $100, resulting in no DOI income. Under the capital-contribution rule, the $100 debt would be deemed satisfied by the corporation in an amount equal to the shareholder's basis in the debt ($100 in the facts), also resulting in no DOI income.

of DOI income may differ depending on whether it is determined under the I.R.C. section 108(e)(6) capital-contribution rules or the I.R.C. section 108(e)(8) stock-for-debt rules. In general, the capital-contribution rules are more advantageous if the shareholder's basis in the debt exceeds the fair market value of the debt.[105] However, the stock-for-debt rules are generally preferable if the fair market value of the debt is greater than the shareholder's basis.

Even if the stock-for-debt treatment is advantageous for the debtor, the shareholder may be exposed to adverse tax consequences. The debtor corporation might avoid DOI income, but the shareholder has a gain to the extent, if any, the value of the stock used to satisfy the debt exceeds the shareholder's basis in the debt. There is an exception to this rule where the debt is a "security" (generally, an instrument with a maturity longer than 5 years). In that case, the transaction could qualify as a recapitalization[106] or a tax-free exchange.[107]

(d) Debt for Debt: Section 108(e)(10)

DOI income may be realized if one debt is issued in satisfaction of another debt. I.R.C. section 108(e)(10) generally involves the satisfaction of a debt instrument (the "old debt") by the debtor's issuance of another debt instrument (the "new debt"). For purposes of determining DOI income, the debtor is treated as having satisfied the old debt with an amount of money equal to the issue price of the new debt.

(i) Background

Prior to the passage of the Revenue Reconciliation Act of 1990, I.R.C. section 1275(a)(4) provided that, if any debt instrument was issued in a reorganization in exchange for any other debt instrument, and the issue price of the new debt was less than the adjusted issue price of the old debt, then the issue price of the new debt would be treated as equal to the adjusted issue price of the old debt. The result was that no gain was realized in the exchange.

The IRS sought the repeal of this rule and redoubled its efforts following the Bankruptcy Court's decision in *In re Chateaugay Corp*.[108] The 1990 Act repealed

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[105] A shareholder's basis in the debt may be less than fair market value for many reasons, including the following: (1) The stock and a debt security were received upon the creation of the debtor corporation on or before October 2, 1989 (the effective date of the 1989 Tax Act that treated securities received in an I.R.C. section 351 transfer as boot), and the basis of the assets transferred was apportioned to the stock and debt based on relative fair market of the stock and debt received; (2) If (a) an accrual-basis corporation, owes a cash-basis shareholder, $1,000, (b) a consolidated return is not filed that includes the corporation and the shareholder, and (c) the debtor corporation accrues and deducts (but does not pay) $300 of interest, then the shareholder's basis in the debt will be $1,000 and the face will be $1,300; or (3) The shareholder may have acquired the corporation's debt from an unrelated party at a discount prior to the shareholder's acquisition of the stock of S. If I.R.C. section 108(e)(4) (acquisition by related member treated as an acquisition by the member itself) does not apply, P's basis in the debt will be less than face.

[106] I.R.C. § 368(a)(1)(E).

[107] I.R.C. § 351(d)(2).

[108] 109 B.R. 51 (Bankr. S.D.N.Y. 1990), *aff'd in part, rev'd in part*, 961 F.2d 378 (2d Cir. 1992).

I.R.C. section 1275(a)(4) and revised I.R.C. section 108(e)(11) to provide that taxpayers would realize DOI income to the extent of the excess of the adjusted issue price of the old debt over the issue price of the new debt. The issue price of the new debt was (and is) determined under I.R.C. sections 1273 and 1274. I.R.C. section 108(e)(11) was subsequently redesignated as I.R.C. section 108(e)(10) in the Omnibus Revenue Reconciliation Act of 1993.[109]

(ii) Publicly Traded Debt versus Non-Publicly Traded Debt

Under current law, the issue price of the new debt is a key factor when determining DOI income because the debtor is treated as if it paid that amount for the new debt. If either the old debt or the new debt is publicly traded, the issue price of the new debt is determined by the public trading price.[110] An instrument is generally "publicly traded" if it is part 9of an issue that is traded (in whole or in part) on an established securities market or issued for securities that are traded on an established securities market.[111]

A report by the House Committee on Ways and Means[112] contains the following illustration of an exchange of publicly traded debt:

> A corporation issued for $1,000 a bond that provided for annual coupon payments based on a market rate of interest. The bond is publicly traded. Some time later, when the old bond is worth $600, the corporation exchanges the old bond for a new bond that has a stated redemption price at maturity of $750. The exchange is treated as a realization event under section 1001. Under the bill, the new bond will have an issue price of $600 (the fair market value of the old bond) and deductible OID of $150 ($750 stated redemption price at maturity less $600 issue price) and the corporation will have COD of $400 ($1,000 adjusted issue price of the old bond less $600 issue price of the new bond). Such results will occur whether or not the exchange qualifies as a reorganization.

If neither the old debt nor the new debt is publicly traded, the issue price of the new debt is determined under I.R.C. section 1274.[113] That section states that:

- Where the instrument has "adequate stated interest" (i.e., generally the instrument bears a rate of interest equal to or in excess of the applicable federal rate and the interest is unconditionally payable at least annually), the issue price equals the stated principal amount; and

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[109] P.L. 103-66, section 13226(a)(1)(A)-(B).

[110] I.R.C. § 1273(b)(3).

[111] An instrument is traded on an established securities market if, at any time during the 60-day period ending 30 days after the issue date: (i) the security is listed on a registered national securities exchange (e.g., the NYSE, the AMEX); an inter-dealer quotation system sponsored by a national securities association, or certain foreign exchanges; (ii) the security trades on a contract market board of trade; (iii) the security appears on a system of general circulation (a quotation medium); or (iv) dealers and brokers have readily available price quotations with respect to the security. Treas. Reg. §1.1273-2(f).

[112] H.R. Rep. No. 881, 101st Cong., 2d Sess. 355 (1990).

[113] For debt instruments subject to interest on deferred payments under I.R.C. section 483 (rather than I.R.C. section 1274), the issue price, determined under I.R.C. section 1273(b)(4), is reduced to exclude unstated interest for purposes of determining DOI income.

- In other cases, the issue price is the "imputed principal amount," which generally equals the net present value of all payments due under the new debt determined using a discount rate equal to the applicable federal rate, compounded semiannually.

Aside from the general rules, I.R.C. sections 1273 and 1274 and the regulations provide guidance for specialized situations. Treas. Reg. section 1.1274-2(g) contains a special rule for contingent-payment non-publicly traded debt. Application of that rule to a debt-for-debt situation may produce an inequitable result. For example, assume there is a "significant modification" of a debt (discussed next in § 2.4(d)(iii)) that triggers I.R.C. section 108(e)(10). The old debt has a $100 adjusted issue price and a fixed rate of interest. Neither the new debt nor the old debt is publicly traded. The new debt provides only for payments that are contingent on future events (such as future profitability). Because the new debt is not publicly traded and includes contingent payments, the adjusted issue price of the new debt could be determined under Treas. Reg. section 1.1274-2(g) to be zero. An issue price of zero means that the debtor has $100 of DOI income. Given this seemingly inappropriate result, it is arguable that the special rule should not apply in the discharge of indebtedness context.

(iii) Significant Modification of a Debt Instrument

I.R.C. section 108(e)(10) not only applies to situations in which an old debt instrument is exchanged by the holder for a new debt instrument, but that section also applies to situations in which a significant change in the terms of the old instrument rises to the level of an exchange that is a realization event for federal income tax purposes. A *change* to a debt instrument does not necessarily have any tax impact; but an *exchange* will be subject to the provisions of I.R.C. section 108(e)(10) and may therefore give rise to DOI income.

The distinction between a mere modification and an exchange is not always clear.[114] In 1996, the government issued regulations under I.R.C. section 1001 that address this matter and provide some bright-line rules. These rules turn on whether a *modification* occurred and, if so, whether the modification is *significant.* A significant modification is an exchange subject to the I.R.C. section 108(e)(10) debt-for-debt rule.

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[114] Consider authorities that existed prior to the 1001 regulations. *E.g.* Rev. Rul. 73-160, 1973-1 C.B. 365 (extension of maturity date and subordination is not an exchange); Rev. Rul. 82-188, 1982-2 C.B. 90 (increase in principal amount and elimination of conversion feature of a convertible installment note is an exchange). A 1991 United States Supreme Court case contributed to the uncertainty. *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991) (involving an exchange of mortgage portfolios by two savings and loan associations that constituted a material modification). Prior to *Cottage Savings,* a variety of rulings and determinations addressed whether a modification of the terms of a debt instrument triggered an exchange. *See, e.g.,* Rev. Rul. 89-122, 1989-2 C.B. 200 (principal amount); Rev. Rul. 87-19, 1987-1 C.B. 249 (rate of interest); General Counsel Memoranda 39225 (Apr. 27, 1984) (principal obligor).

(A) Modification

Treas. Reg. section 1.1001-3 provides that almost all changes in the terms of a debt instrument are considered a modification of the indebtedness. However, changes that are the result of the terms of the instrument (e.g., a change in the interest rate as provided for in a variable rate loan) are generally not considered modifications.[115] Other examples of adjustments allowed by the terms of the debt instrument that are not modifications under the regulations include:

- The resetting of the interest rate every 2 months
- The substitution of collateral when the original collateral depreciates
- The drop in interest rate as a bond is registered
- The conversion of an adjustable mortgage to a fixed mortgage

The allowance of debt-instrument-provided adjustments is severely limited, however. Each of the following items is considered a modification, even if it occurs under the terms of the debt instrument:

- Change that converts the debt to something that is not debt for federal income tax purposes (unless the holder exercises an option to convert the debt to equity of the issuer)
- Change in the debtor, the addition or deletion of a co-obligor on the debt
- Change from recourse to nonrecourse debt, or vice versa
- Changes that result from the exercise of certain options.[116]

(B) Significant Modification

If the modification is "significant," as defined in the regulations, the modification is a realization event. The significant modification of a debt instrument is treated as an exchange of the old debt instrument for a new debt instrument, so the I.R.C. section 108(e)(10) debt-for-debt rules could apply to trigger DOI income for the debtor.

Under the "general significance rule" in Treas. Reg. section 1.1001-3(e)(1), a modification is significant if, based on all the facts and circumstances, the legal rights or obligations being changed and the degree to which they are being changed are economically significant.

The general significance rule is broad and applies to a modification that is effective upon the occurrence of a substantial contingency. Moreover, the general significance rule applies to modifications that are effective on a substantially deferred basis. When testing a modification under the general significance rule, all modifications made to the instrument (other than those for which specific

[115] *See* Treas. Reg. § 1.1001-3(c).

[116] Generally, the exercise of an option is a modification unless the option is unilateral. In addition, an option exercised by the *creditor* (as opposed to the debtor) is a modification, unless the exercise does not defer or reduce scheduled payments of interest or principal. See Treas. Reg. § 1.1001-3(c)(2)(iii). For example, the option by a bank (the creditor) to reduce interest rates to keep a customer if rates decline is a modification, but the bank's exercise of an option to increase the rates due to the decline in the financial conditions of the issuer is not a modification. Treas. Reg. § 1.1001-3(d), Examples 7, 9.

bright-line rules are provided) are considered collectively. Thus, a series of related modifications, each of which independently is not significant under the general significance rule, may together constitute a significant modification.

The regulations provide a number of bright-line tests to determine significance for the following areas: change in yield, change in timing of payments, change in obligor or security, change in the nature of the instrument.

(1) Change in Yield A change in yield is significant if the modified yield varies from the old debt interest rate by more than the greater of (1) 25 basis points or (2) five percent of the annual yield. This rule gives the same weight to changes in the principal amount as to changes in the interest payments.

(2) Change in Timing of Payments A change in timing is a significant modification if it results in a material deferral in scheduled payments. A deferral could occur through either an extension of the final maturity date or a deferral of payments due prior to maturity. The materiality of the deferral is a facts and circumstances test that takes into account the length of deferral, the original terms of the instrument, the amount of payments that are deferred, and other material factors. The regulations provide a safe harbor for a period of time equal to the lesser of 5 years or 50 percent of the original term of the debt instrument.[117] The period begins on the due date of the first scheduled payment (i.e., principal or interest) that is deferred. This period does not take into account an option to extend the original maturity and deferrals of de minimis payments. Because an extension of maturity or reduction of principal may affect yield, the changed instrument must also be tested under the change-in-yield test described above.

(3) Change in Obligor or Security The consequence of a change in obligor depends on various factors, including whether the obligation is recourse or nonrecourse. The substitution of a new obligor on a recourse debt instrument is a significant modification unless (1) the change is a result of an I.R.C. section 381(a) transaction (provided there is no change in payment expectations);[118] (2) the new obligor acquires substantially all the assets of the original obligor and there is no change in payment expectations; (3) it is a result of an I.R.C. section 338 election;[119] or (4) it is a result of a bankruptcy filing. The substitution of a new obligor on a nonrecourse debt is not a significant modification. The addition or deletion of a co-obligor will only be treated as a significant modification if there is a change in payment expectations.

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[117] Treas. Reg. § 1.1001-3(e)(3)(ii).

[118] A change in payment expectations occurs when there is (1) a substantial enhancement to the borrower's ability to make payment, the ability was speculative before, and is adequate after the transaction or (2) a substantial impairment in the borrower's ability to make payment, the ability was adequate prior, and is speculative after. In addition, if there is another significant modification, such as a change in yield in connection with an I.R.C. section 381(a) transaction, there will be an exchange of debt instruments. This exchange may remain tax-free from the creditor's perspective if it qualifies as an exchange of securities. *See* Rev. Rul. 2004-78, 2004-31 I.R.B. 108.

[119] This issue arises in the context of an I.R.C. section 338 election because the target is treated as a new corporation after the election is effective.

The recourse or nonrecourse nature of a debt instrument is also important with respect to the significance of a change. The release, substitution, addition, or alteration of collateral, guarantee, or credit enhancement for recourse indebtedness is a significant modification if there has been a change in payment expectations. In the case of a nonrecourse debt, the changes in security, guarantee, or credit enhancement will generally result in a significant modification.

(4) Change in the Nature of the Instrument A significant modification may also arise as a result of a change in the nature of a debt instrument. For example, a modification of a debt instrument that transforms it into something that is not debt is a significant modification.[120] A change in the nature of debt from recourse to nonrecourse or vice versa is a significant modification. The regulations specifically provide that a legal defeasance of a debt instrument releasing the debtor from all liability upon the creation of a trust to fund future payments is a significant modification. Exceptions to these rules exist for a change from recourse to nonrecourse if the instrument remains secured by the same collateral (or fungible collateral) and there is no change in payment expectations. Changes to customary accounting or financial covenants are not significant modifications.

(C) Multiple Modifications

Generally, multiple modifications of a debt instrument over a period of time, such as several changes to the yield, are analyzed on a cumulative basis (unless the changes are more than 5 years apart). However, modifications which fall under the bright-line tests (change in yield, payment expectation, nature, or accounting/financial covenants) are not tested on a cumulative basis. Thus, a change in yield and a change in collateral that are not significant separately could not be added together to result in a significant modification. Changes that are not covered under the bright-line tests are, on the other hand, tested on a cumulative basis.

To recap, if a significant modification occurs, gain or loss may be realized. The debtor's recognition of DOI income under I.R.C. section 108(e)(10) depends on whether the adjusted issue price of the old debt, determined under I.R.C. section 1273 or 1274, is less than or greater than the issue price of the new debt. The creditor's realization of gain or loss generally depends on a comparison of the issue price of the new debt with the creditor's basis in the old debt.

(D) Disregarded Entities

The treatment of entities that are disregarded for federal income tax purposes sometimes further complicates determining whether there is a significant modification of a debt held by a corporation that elects to be a disregarded

[120] For purposes of this rule, deterioration in the financial condition of the obligor is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor. In addition, conversion of the debt into equity of the issuer pursuant to the holder's option is not a modification.

entity.[121] Assume that a parent corporation owns a subsidiary corporation with debt outstanding to an unrelated creditor. The subsidiary makes a check-the-box election to become a disregarded entity. The tax fiction disregards the subsidiary, but it exists for state law purposes. Has there been a change in the identity of the debtor that is a significant modification under the I.R.C. section 1001 regulations? A recent Private Letter Ruling[122] looks to state law to determine legal entitlements, finding that the subsidiary would remain the debtor because the debtor is the legal entity for legal purposes of the debt. In that ruling, there was no modification of the debt, and thus no deemed satisfaction of the debt.

§ 2.5 SECTION 108(e) SUBTRACTIONS FROM DISCHARGE OF INDEBTEDNESS INCOME

To this point, the discussion in this chapter has focused on what is included in DOI income. This section focuses on what is excluded from DOI income.

(a) Otherwise Deductible Debts: Section 108(e)(2)

I.R.C. section 108(e)(2) provides that no income will be realized from the discharge of indebtedness to the extent that *payment* of the indebtedness would have given rise to a deduction.[123] This means that no income will be realized if creditors forgive the expenses of a cash-basis taxpayer that were not actually paid.

The purpose of this provision is to place cash-method taxpayers on an equal footing with accrual-method taxpayers. To illustrate, assume that an accrual-method taxpayer has a $100 debt outstanding. In Year 1, $10 of interest accrues and is deducted by the debtor. On January 1, Year 2, the creditor cancels the debt. The debtor would have DOI income of $110 ($100 as a result of principal and $10 as a result of accrued but unpaid interest). I.R.C. section 108(e)(2) would not provide relief for the debtor because the *payment* of the interest would not result in a deduction. The interest was already deducted by the accrual-method debtor. Over the course of the obligation, the debtor deducted $10 of interest in Year 1 and included $110 of DOI income in Year 2 for a net (multi-year) income inclusion of $100.

If, however, the debtor were cash method, there would be no deduction in Year 1 because the interest was not paid. (This assumes that the interest obligation would not be deductible under the original issue discount rules.) If I.R.C. section 108(e)(2) did not exist, the cash-method debtor would include DOI income in the amount of $110 in Year 2 with no offsetting interest deduction in the Year 1. This would penalize the debtor for using the cash method. I.R.C.

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[121] Examples of entities that are subject to disregarded entity treatment include certain domestic and foreign single-member entities (e.g., limited liability companies) to which the check-the-box regulations apply, qualified real estate investment trust subsidiaries, and qualified subchapter S subsidiaries. Treas. Reg. § 301.7701-3.

[122] Private Letter Ruling 200315001 (Sept. 19, 2002) (newly formed company acquires target and then target converts to a limited liability company by making a check-the-box election).

[123] *See*, *e.g.*, Private Letter Ruling 200243034 (July 26, 2002) (I.R.C. section 108(e)(2) exception applies because payment of discharged liquidated tort and environmental claims would have been deductible under I.R.C. section 162(a)).

section 108(e)(2) comes to the rescue, permitting the cash-method debtor to exclude $10 of accrued and unpaid interest because the *payment* of the interest would result in a deduction. The cash-method debtor would include $100 of DOI income in Year 2 for a total of $100 of net income over the course of the loan, thus placing the accrual-method and cash-method debtors in general parity.

Anomalies may result if a debt is partially satisfied. Reconsider the basic facts in the prior paragraph. A debtor has $110 of debt outstanding ($100 of principal and $10 due to interest that accrued in Year 1, but remains unpaid). This time, on January 1 of Year 2 the debtor reaches an agreement with the debtor to retire the $110 of debt for a payment of $80. Under current law, the payment generally would be first allocated to interest and then to principal.[124] Thus, $10 would be allocated to the interest component, resulting in a $10 deduction. The remaining $70 of consideration would be allocated to the outstanding principal, resulting in DOI income of $30 ($100 principal less $70 remaining consideration). Although this appears to wash (DOI income of $20 versus DOI income of $30 with an offsetting interest deduction of $10), subtle, yet important differences may exist. For instance, if the debtor were bankrupt or insolvent and able to exclude the DOI income, as discussed in §§ 2.6(a)-(b), it may be more advantageous to generate a deduction in the year of discharge to offset other income.

(b) Purchase Price Reduction: Section 108(e)(5)

When a debt arises out of the purchase of property, the cancellation or reduction of the amount due may be treated as a reduction of the purchase price, rather than as income. If the discharge is treated as a purchase price reduction, the debtor generally reduces basis in the purchased property and does not recognize DOI income. This rule of law was initially developed by the courts and later codified in I.R.C. section 108(e)(5).[125] That section provides seven basic factors that must be satisfied:

1. The debt is a debt of the purchaser of property,
2. The debt is owed to the seller of property,
3. The debt arose out of the purchase of property,
4. The debt is reduced,
5. The reduction does not occur in a title 11 case or when the debtor is insolvent,
6. But for this provision, such decrease would be treated as income to the purchaser from the discharge of indebtedness, and
7. Other factors, as noted in the legislative history.

[124] Treas. Reg. § 1.442-2. Under prior law, the taxpayer could choose to allocate the payment to interest or principal. For instance, if a cash-method debtor chose to allocate the payment to principal first, the debtor would realize $20 of DOI income attributable to principal reduction ($100 principal less $80 payment) and no DOI income as a result of the $10 of discharged interest under I.R.C. section 108(e)(2). *See* § 2.4(b)(ii) for a discussion of allocation between principal and interest.

[125] *See* Helvering v. Killian Co., 128 F.2d 433 (8th Cir. 1942); Bankruptcy Tax Act of 1980, Pub. L. 96-589, 94 Stat. 3389.

Although this statutory exception appears to codify the principles of case law, it is in some ways much broader.[126] Unlike the judicial exception, the statutory exception is not limited by property values, and it is not necessary for the parties to have renegotiated the original purchase price.

The provision is mandatory if the debtor is solvent. Thus, a debtor preferring to report the debt discharge as income (to reduce an expiring net operating loss carryover, for example) will not be able to do so.

The legislative history of I.R.C. section 108(e)(5) describes a number of transactions that are not covered; for example, the section does not apply if the creditor who agreed to the reduction is not the original seller or if the debtor does not own the property at the time of the reduction.[127] Moreover, the purchase price reduction rule does not apply if the debt is reduced for reasons not involving direct agreements between the buyer and the seller, such as expiration of the statute of limitations on enforcement of the obligation.[128] These exceptions are contained in legislative history and do not have the force of a statute.

Determining whether the factors of I.R.C. section 108(e)(5) are satisfied is deceivingly difficult.[129] The intricacies of many transactions do not make the task any easier. For example, in a Technical Advice Memorandum,[130] the steps taken by the parties did not satisfy the I.R.C. section 108(e)(5) factors. However, the IRS recast the form of a transaction by disregarding a transitory entity.[131] As recast, the form of the transaction looked like a purchase in exchange for debt, and as such, I.R.C. section 108(e)(5) applied.

(i) Creditor That Is Not Seller

The purchase price reduction treatment of section 108(e)(5) is generally not available if the creditor who discharges the debt incurred for the purchase of property was not the seller of the property. There is an "infirmity exception" to this general rule if the reduction is based on an infirmity that clearly relates back to the original sale, such as the seller's fraud or material misrepresentation.

In Revenue Ruling 92-99,[132] the IRS concluded that the cancellation of "non-seller-financed" acquisition debt generally results in DOI income when

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[126] *See Allen v. Courts*, 127 F.2d 127 (5th Cir. 1942); *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940).

[127] H.R. Rep. No. 833, 96th Cong., 2d Sess. 13 (1980). See also *Bressi v. Commissioner*, 62 T.C.M. (CCH) 1668 (1991), *aff'd without opinion*, 1993 U.S. App. LEXIS 5320 (3d Cir. 1993) (I.R.C. section 108(e)(5) does not apply where taxpayer did not demonstrate that purchaser's debt was owed to seller).

[128] H.R. Rep. No. 833, 96th Cong., 2d Sess. 13 (1980).

[129] *See also* Private Letter Ruling 9037033 (June 18, 1990) (involving a purchase of stock by buyer for purchase money indebtedness followed by a transfer of the purchased stock to a corporation, which assumed the purchase money indebtedness; finding the corporation was the imputed purchaser of the stock for purposes of purchase price adjustment).

[130] Technical Advice Memorandum 9338049 (June 15, 1993).

[131] That is, as part of the same plan or arrangement, a corporation may be both created and dissolved. These types of corporations are transitory—born to die. Under the transitory entity doctrine, the IRS ignored the existence of a corporation that was transitory.

[132] 1992-2 C.B. 35.

the principal amount of the debt is reduced to the fair market value of the underlying security. In the ruling, A purchased property from B for $1 million, financed with a $1 million nonrecourse loan from unrelated lender C. Subsequently, when the fair market value of the property was $800,000 and the debt principal was still $1 million, C reduced the amount due to $800,000. (The ruling does not indicate what A's basis was at the time of the debt reduction.) The IRS ruled that A had DOI income. Because the debt reduction by the unrelated lender C was not based "on an infirmity that clearly relates back to the original sale," there was no purchase price adjustment. Although the IRS generally will not follow other judicially created exceptions to income recognition for discharge of acquisition debt, the IRS will treat a debt reduction in unrelated lender cases as a purchase price adjustment to the extent allowed by the infirmity exception.

In *Preslar v. Commissioner,*[133] the Tenth Circuit Court of Appeals reached a conclusion similar to Revenue Ruling 92-99—DOI income rather than a purchase price reduction. In *Preslar,* the taxpayers purchased a ranch from a financially troubled seller. Moncor Bank, one of several banks that held the seller's mortgage on the ranch, financed the purchase. The taxpayers received title to the ranch free and clear of all prior mortgages. The taxpayers developed the ranch into a sportsman's resort by subdividing the property into lots for cabins. Moncor Bank permitted the taxpayers to repay the loan by assigning the installment sale contracts from purchasers of the cabin lots to the bank at a 5 percent discount. This repayment arrangement was not memorialized in the loan documents. Moncor Bank was also financially troubled, declared insolvent, and placed in receivership with the Federal Deposit Insurance Corporation (FDIC). The FDIC refused to accept further assignments of sale contracts as repayment. The taxpayers sued the FDIC for refusing to accept additional assignments and the FDIC settled the lawsuit by discharging more than 50 percent of the remaining loan balance.

Relying on the I.R.C. section 108(e)(5) purchase price reduction, the taxpayers reduced their basis in the ranch by the amount of debt discharged rather than reporting DOI income. The Tenth Circuit held that the taxpayers realized DOI income because title to the ranch never passed to Moncor Bank; as a result, the purchase-price-reduction rule was not available to the taxpayers. The Tenth Circuit also held that the dispute with the FDIC did not relate back to the original sale; thus, the infirmity exception was inapplicable. *Preslar* is consistent with Rev. Rul. 92-99, which limits a purchase price adjustment to cases in which the direct seller discharges the debt, unless the infirmity exception applies. As shown in *Preslar*, sometimes the purchase price reduction rule and the contested liability doctrine are invoked in the same transaction.[134]

See § 2.8(a)(i)(A) for a discussion of *Sands v. Commissioner,*[135] in which the Tax Court held that a partnership's transfer of property in satisfaction of non-

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[133] 167 F.3d 1323 (10th Cir. 1999), *rev'g* 72 T.C.M. (CCH) 1496 (1996).

[134] *See* § 2.3(a)(vi) for a discussion of this case and the contested liability doctrine.

[135] 73 T.C.M. (CCH) 2398 (1997), *aff'd*, 164 F.3d 618.

recourse indebtedness did not result in DOI income and, therefore, could not qualify as a purchase price reduction under I.R.C. section 108(e)(5).

(ii) Solvent Debtor

Only a solvent taxpayer can take advantage of the I.R.C. section 108(e)(5) purchase price reduction. But if an insolvent debtor is pushed into solvency by a purchase price reduction, the transaction is bifurcated and I.R.C. section 108(e)(5) only applies to the extent the taxpayer is solvent.

To illustrate this point, assume a corporation has $180 of assets ($100 of cash and a machine with a fair market value of $80) and $200 in liabilities, consisting of a $90 debt to an unrelated creditor and a recourse $110 debt to the seller of the machine. The $110 debt is reduced by $30 to $80. The IRS bifurcates the transaction. To the extent of the taxpayer's insolvency ($20), the discharge of indebtedness is not covered by I.R.C. section 108(e)(5) and the corporation has $20 in DOI income. (As discussed in §§ 2.6(b), 2.7(d)(i), this amount is excluded from income under the I.R.C. section 108(a)(1)(B) insolvency exception with attendant attribute reduction of $20 pursuant to section 108(b).) The balance of the discharge ($10) is treated as an I.R.C. section 108(b)(5) purchase price adjustment, which reduces the basis in the machine by $10.

(c) Summary

Taxpayers wishing to avail themselves of the I.R.C. section 108(a) exclusions must first determine whether and to what extent their income is DOI income. Such income includes income deemed by rulings and case law to be I.R.C. section 61(a)(12) income, increased by income meeting the requirements of I.R.C. section 108(e)(4), (e)(6), (e)(8), and (e)(10) (and the modification regulations), and decreased by income meeting the requirements of I.R.C. section 108(e)(2) and (e)(5). Once it is determined that a taxpayer's income is DOI income, that income may be excluded from gross income if the taxpayer demonstrates that the discharge qualifies as a:

- Title 11 case exclusion
- Insolvency exclusion
- Discharge of qualified farm indebtedness exclusion, or
- Discharge of qualified real property business indebtedness exclusion.

Even if a taxpayer excludes DOI income under one of the four exclusions, the taxpayer generally must offset the amount discharged by the reduction of certain tax attributes under section 108(b).

§ 2.6 DISCHARGE OF INDEBTEDNESS INCOME EXCLUSIONS

The financial and legal status of the debtor determines which of the I.R.C. section 108(a) exclusions (if any) apply to DOI income. Categorization of the taxpayer as insolvent, solvent, or in a title 11 case drives the tax treatment. Favorable tax treatment is also allowed for qualified farm debt and qualified real property business indebtedness.

(a) Title 11 Exclusion

The title 11 exclusion of I.R.C. section 108(a)(1)(A) provides that a debtor in a title 11 case excludes DOI income from gross income. Different treatment is provided for a debtor who is insolvent, but not under the jurisdiction of the bankruptcy court in a title 11 case.[136] The term "title 11 case" means a case within the jurisdiction of the bankruptcy court under title 11 of the Bankruptcy Code, but only applies if the discharge of indebtedness is granted by the court or is pursuant to a court-approved plan.[137]

If one of the other three exclusions also applies to a discharge, then the title 11 exclusion trumps. The title 11 exclusion may be preferable for some debtors because, unlike the insolvency exclusion, income can be excluded under the title 11 exclusion even if the discharge renders the debtor solvent.

If a disregarded entity[138] in a title 11 case has DOI income, the disregarded entity may take the position that the DOI income is excluded from gross income under the title 11 exclusion, whether or not the owner of the disregarded entity is in bankruptcy. This position may be supported by analogy to the conclusion of the Tax Court in a series of related cases involving a partnership. In those cases, the partnership, not the partners, were in a title 11 case. For partnerships, the title 11 exclusion is applied at the partner level.[139] Rather than looking to the status of the partners, the Tax Court held that the title 11 exclusion applied where the partnership satisfied its requirements.[140]

(b) Insolvency Exclusion

The insolvency exclusion of I.R.C. section 108(b)(1)(B) excludes DOI income from gross income if the discharge occurs when the taxpayer is insolvent. The insolvency exclusion is a judicially developed doctrine added to the I.R.C. as

[136] *See* § 1.2.

[137] I.R.C. § 108(d)(2). Application of the title 11 exclusion is somewhat unclear in a liquidating bankruptcy under chapter 7 because a corporate debtor is not granted a discharge. This rule applies to debtors who, like corporations, are not individuals. Bankruptcy Code §§ 727(a)(1), 1141(d)(3). There are three possible outcomes for a liquidating bankruptcy. First, there is no DOI income because no discharge occurred. *See Friedman v. Commissioner*, 216 F.3d 537, 548 n.7 (6th Cir. 2000). Second, either actual or de facto DOI income occurs as the result of the liquidation, but the DOI income is not excluded from gross income under the title 11 exclusion because the bankruptcy court did not grant or approve the discharge. Third, there is DOI income as a result of a court-approved liquidation, and the title 11 exclusion applies to exclude the DOI income from gross income because the discharge occurs pursuant to a plan approved by the court.

[138] *See* n. 121.

[139] I.R.C. § 108(d)(6).

[140] *Estate of Martinez v. Commissioner*, 87 T.C.M. 1428 (T.C. 2004); *Price v. Commissioner*, 87 T.C.M. 1426 (T.C. 2004); Merarchi v. Commissioner, 87 T.C.M. 1424 (T.C. 2004); Gracia v. Commissioner, 87 T.C.M. 1423 (T.C. 2004). It is more difficult to take the position that the insolvency exclusion, discussed in §2.6(b), applies to an insolvent disregarded entity even though the owners of the disregarded entity are solvent. *See Gershkowitz v. Commissioner*, 88 T.C. 984 (1987) (applying the insolvency exclusion at the partner, not partnership level). *See also* 2925 Briarpark, Ltd., 163 F.3d 313 (5th Cir. 1999).

part of the Bankruptcy Tax Act of 1980.[141] For debt discharged outside a title 11 case, the determination of the extent to which the debtor is insolvent is critical because, absent the applicability of another exclusion, the insolvency exclusion is limited to the extent of the debtor's insolvency.[142]

I.R.C. section 108(d)(3) defines the term "insolvent" as the amount by which liabilities exceed the fair market value of assets. Thus, in an out-of-court settlement where the debt outstanding is $10 million, the fair market value of the assets is $7 million, and $4 million of debt is cancelled; $3 million would fall under the insolvency exclusion and $1 million would be included in income.

Determination of fair market value can be difficult. The courts have used different methodologies to determine value. In cases under the Bankruptcy Act, the courts have used the going-concern concept for valuation of assets and liabilities.[143] Applying that concept, goodwill, going-concern value, and any off-balance-sheet intangibles should be included in the value. For many years, the going-concern value for bankruptcy purposes was determined by estimating the earnings and multiplying this value by a capitalization multiple. The Tax Court in *Concord Control, Inc. v. Commissioner*[144] used the capitalization approach to determine how the purchase price was to be allocated between tangible and intangible assets. Concord did not involve the valuation of a company in bankruptcy, but it indicates that the capitalization method may be appropriate for tax purposes.[145] Another aspect of calculating insolvency is identifying and valuing both liabilities and assets.

(i) Liabilities

Proving insolvency is fundamentally an evidentiary matter.[146] The valuation of the debtor's liabilities can be difficult, especially if the debt is contingent or nonrecourse. If a debt is nonrecourse (i.e., secured by a piece of property and no personal liability), and the amount of debt exceeds the value of the property, one must determine how much of the nonrecourse debt should be included in determining solvency or insolvency. Counting the nonrecourse liability in excess of the fair market value of the property securing the debt in the insolvency calculation would increase the amount of the debtor's insolvency and consequent ability to exclude DOI income. This may not reflect economic reality because the

[141] S. Rep. No. 1035, 96th Cong. 2d Sess. at 8 (1980); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934) (superseded by I.R.C.).
[142] I.R.C. § 108(a)(3).
[143] *See* Newton, *Bankruptcy and Insolvency Accounting: Practice and Procedure*, Ch. 11 (undated annually).
[144] 78 T.C. 742 (1982), *acq.*, 1984-1 C.B. 1.
[145] *See also Phillip Morris Inc. v. Commissioner*, 96 T.C. 606 (1991), *aff'd*, 970 F.2d 897 (2d Cir. 1992) (using capitalization or excess-earnings method to value corporation in I.R.C. section 332 case); T.D. 8530, 59 Fed. Reg. 12840 (Mar. 18, 1994) (preamble) (going-concern valuation may be used to value assets under I.R.C. section 382(l)(6)).
[146] The Eighth Circuit reversed the Tax Court's demand for explicit proof that judgments against the taxpayer remained unsatisfied as "wholly unreasonable" and held that the taxpayer was insolvent. *Toberman v. Commissioner*, 294 F.3d 985 (8th Cir. 2002), *rev'g* 80 T.C.M. (CCH) 81 (2000).

debtor is not liable for the excess. Recognizing this, the IRS allows a taxpayer to include nonrecourse debt up to the value of the property securing the debt plus the excess nonrecourse debt (nonrecourse debt in excess of the fair market value of the security) as a liability when calculating insolvency, but limited to the amount of the excess debt actually discharged.

The IRS took this position in Rev. Rul. 92-53,[147] determining that the amount by which nonrecourse debt exceeds the fair market value of property securing the debt (excess nonrecourse debt) should be treated as a liability in determining insolvency under I.R.C. section 108(a)(1)(B), but only to the extent the excess nonrecourse debt is discharged in the same transaction. The revenue ruling included the following example. M owns property 1 (fair market value of $800,000 subject to nonrecourse debt of $1,000,000) and property 2 (fair market value of $100,000). M is also personally liable for debts of $50,000. If M's creditor reduces the $1,000,000 nonrecourse debt to $825,000, M has excess nonrecourse debt discharged of $175,000. As a result, M will have total liabilities of $1,025,000 ($50,000 personal liability + $800,000 fair market value of property secured by nonrecourse debt + $175,000 excess nonrecourse debt discharged). The excess of these total liabilities ($1,025,000) over the fair market value of total assets ($900,000) is M's insolvency ($125,000). The insolvency exclusion applies to the extent of M's insolvency, $125,000. Only the excess of the DOI income ($175,000) over the extent of insolvency ($125,000), or $50,000, will be included in income. Similarly, if M's $50,000 debt is satisfied for property worth $40,000 (basis is also $40,000), there is $10,000 of DOI income. M is solvent because the excess nonrecourse debt is not counted; it is not discharged.

Contingent liabilities may be disregarded when determining whether the debtor is insolvent pursuant to I.R.C. section 108(d)(3). To prove insolvency, the debtor may only count the liabilities the debtor will likely be called upon to pay. This issue was addressed in *Merkel v. Commissioner*.[148] The taxpayers in *Merkel* owned a corporation that borrowed more than $3 million from a bank. The shareholders were required to guarantee the debt. When the corporation defaulted on the debt, the shareholders' guarantee became a fixed and unconditional obligation. After the default, the corporation and the shareholders entered into an agreement with the bank. The bank agreed to cancel the remaining balance for $1.1 million and to release the shareholders' liability if the corporation and the shareholders did not file for bankruptcy within 400 days from the date on which the corporation would make the reduced payment (settlement date). Thus, as a result of the agreement, the shareholders' fixed obligation was replaced with a contingent obligation.

The shareholders realized DOI income from another source that was realized at a time when the shareholders' obligation to the bank was contingent (i.e., after the settlement date but before the completion of the 400-day period). The shareholders excluded DOI income under the insolvency exclusion. To calculate insolvency, the shareholders included their contingent obligations due to the bank debt. The Tax Court and the Ninth Circuit disagreed with this treatment.

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[147] 1992-2 C.B. 48.

[148] 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

In concluding that contingent obligations should not be counted for purposes of determining insolvency, both the Tax Court and the Ninth Circuit examined the freeing-of-assets theory, which underlies the insolvency exclusion.[149] Under this theory, a debtor should realize DOI income due to the cancellation of a debt only if the debtor's post-discharge liabilities do not exceed the value of the debtor's post-discharge assets. Fundamental to the freeing-of-the-assets theory is a level of certainty that the debtor's obligations truly offset its assets, because the obligations are ones that the taxpayer will be called on to pay. The courts found that, because Congress indicated that the purpose of the insolvency exclusion was to avoid burdening insolvent taxpayers with an immediate tax liability, the ability to pay an immediate tax was a controlling factor with respect to whether a tax should be imposed. In general, to convince the courts that a taxpayer will be called on to pay an obligation, the proponent must satisfy a "preponderance of the evidence" standard. This requires the proponent to prove a fact to be more likely than not. To claim the benefits of the insolvency exclusion the debtor must prove that it is more probable than not that the debtor will be called upon to pay each obligation in the amount claimed and that the total liabilities so proved exceed the fair market value of debtor's assets. Applying this approach, the courts did not allow contingent liabilities arising from taxpayers' guarantees to be included for purposes of determining whether the taxpayers were insolvent.

(ii) Assets

Determining which assets of a debtor are included for purposes of the insolvency exclusion has also raised issues. For example, to determine whether the debtor is solvent or insolvent, should assets that are exempt from creditor's claims under state law be considered? Under current law, exempt assets are considered when determining whether a debtor is insolvent under I.R.C. 108(d)(3), but this was not always the case.

Under the judicially created insolvency exclusion for DOI income, exempt assets were not considered in determining the solvency or insolvency of the debtor for out-of-court workouts.[150] The IRS traditionally followed this rule, but in recent years, the IRS had reversed its position, setting the stage for resolution by the Tax Court in *Carlson v. Commissioner*.[151] In *Carlson*, the Tax Court held that assets that are exempt from the claims of creditors under state law are counted when measuring insolvency. The Tax Court rejected any interpretation of the court-created insolvency exclusion that had not been codified. I.R.C. section 108(e)(1) specifically states that, except as provided in I.R.C. section 108, "there shall be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness." The Tax Court in *Carlson*

[149] *See*, *e.g.*, United States v. Kirby Lumber, 284 U.S. 1 (1931).

[150] *Fifth Avenue-Fourteenth Street Corp. v. Commissioner*, 147 F.2d 453 (2d Cir. 1944); *Davis v. Commissioner*, 69 T.C. 814 (1978); *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919 (1989).

[151] 116 T.C. 87 (2001). *See* Private Letter Ruling 9932013 (May 4, 1999) (revoking Private Letter Ruling 9125010 (Mar. 19, 1991)); Field Service Advice 9932019 (May 10, 1999).

concluded that this directive precludes the courts from relying on any judicial understanding of the insolvency exclusion that was not later codified.[152]

As in *Merkel*, the Tax Court distinguished between the definition of "insolvent" in the Bankruptcy Act and in I.R.C. section 108(d)(3). The Tax Court found that Congress intended to exclude exempt assets for purposes of determining solvency in bankruptcy proceedings and intended to include exempt assets for purposes of determining entitlement to the insolvency exclusion. The Tax Court focused the inquiry on the ability of the debtor to pay an immediate tax on income from the discharge of indebtedness. In *Carlson*, the taxpayer's assets (including exempt assets) exceeded the taxpayer's liabilities, thus, the taxpayer had the ability to pay the tax.[153]

(iii) Timing

Notice that insolvency is determined when DOI income occurs, so any increase in the taxpayer's solvency due to the discharge is not considered when determining what is excludable. I.R.C. section 108(d)(3) states "whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge." The term "immediately before the discharge" is not defined in the I.R.C. or in legislative history. For simple cases involving only debt forgiveness, the application of this provision is clear. But, consider a situation where debt discharge is included in a settlement that involves issuance of stock for debt, contribution of new capital, and other reorganization techniques. The taxpayer may be able to plan to be solvent or insolvent based on the ordering of each of the transactions.[154] In most situations, it would be best to have the debt discharged first and to have the taxpayer insolvent by the largest possible amount just before the discharge. There might, however, be situations where the taxpayer would like to have income realized from debt discharge. Thus, until the meaning of this provision is clarified through either technical amendments or case law, the timing of the reorganization transaction should be carefully considered to obtain the maximum tax benefit.[155]

(c) Qualified Farm Indebtedness Exclusion

The Tax Reform Act of 1986 contained a special provision for handling debt discharge by farmers. I.R.C. section 108(g) initially had provided that income from debt discharge by solvent farmers was handled as if the farmers were insolvent. Thus, tax attributes, including the basis of property, were reduced. Special rules

[152] *See also Gitlitz v. Commissioner*, 531 U.S. 206, 215 (2001).

[153] The same issue arises with respect to the proper treatment of benefits from pension funds. *See*, *e.g.*, *Patterson v. Shumate*, 504 U.S. 753 (1992) (although debtor's retirement funds cannot be attached in bankruptcy, these funds are assets for purposes of determining whether the debtor is insolvent).

[154] Scranton, Corporate Transactions Under the Bankruptcy Tax Act of 1980, 35 Tax Law. 49, 78 (1981).

[155] *Id*. *But see* Rev. Rul. 92-52 (the sequence of a debt-for-debt exchange and a stock-for-debt exchange do not matter because the exchanges are related).

applied for basis reduction. The Technical and Miscellaneous Revenue Act (TAMRA) of 1988 significantly changed the debt discharge rules for farm debt.

I.R.C. section 108(a)(1)(C) now provides that income from debt discharge will not be included in gross income if the debt discharged is qualified farm indebtedness.[156] "Qualified farm indebtedness" is indebtedness incurred directly in connection with the operation by the taxpayer of the trade or business of farming, where 50 percent or more of the aggregate gross receipts of the taxpayer for the three tax years immediately prior to the year the discharge occurred is attributable to the trade or business of farming.[157] For determining the 50-percent-or-greater threshold, the proceeds from the sale of farm machinery are considered gross receipts, but income from the rental of farmland is not.[158]

To take advantage of the qualified farm indebtedness exclusion, the debt discharge must be by a "qualified person." Federal, state, and local governments and agencies are automatically considered qualified persons.[159] For all other creditors, a qualified person is defined in I.R.C. section 108(g)(1) by cross-reference to I.R.C. section 49(a)(1)(D)(iv) as a person who is "actively and regularly engaged in the business of lending money," but not any of the following: (1) related to the taxpayer,[160] (2) a person from whom the taxpayer acquired the property, (3) a person who receives a fee with respect to the taxpayer's investment in the property.

The qualified farm indebtedness exclusion will only apply if the exclusions for title 11 cases and insolvency cases do not apply. In other words, the qualified farm indebtedness exclusion applies only to out-of-court settlements where the farmer is solvent at the time debt is discharged or to the extent the farmer becomes solvent as a result of debt being discharged.

The amount of income excluded as qualified farm indebtedness cannot exceed the sum of adjusted tax attributes plus the aggregate adjusted basis of qualified property held by the taxpayer as of the beginning of the tax year following the year in which the discharge occurred.[161] "Qualified property" is defined as any property used or held for use in a trade or business or for the production of income.[162] Thus, to determine how much income the farmer could exclude, the basis of personal use property would not count, including the basis of the farmer's home.

The amount of DOI income from qualified farm indebtedness that can be excluded from gross income may result in a reduction of tax attributes,

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[156] For an example of qualified farm indebtedness, *see Campbell v. Commissioner*, 81 T.C.M. (CCH) 1241 (2001), *aff'd*, 2002-1 U.S. Tax Cas. (CCH) ¶ 50242.

[157] I.R.C. § 108(g)(2).

[158] *Lawinger v. Commissioner*, 103 T.C. 428 (1994).

[159] I.R.C. § 108(g)(2).

[160] A related person is defined by cross-reference to I.R.C. section 465(b)(3)(C).

[161] I.R.C. § 108(g)(3). The tax attributes generally include net operating losses, general business and minimum tax credits, and capital loss, passive activity, credit, and foreign tax credits. Tax attributes that are credits are adjusted by multiplying by three.

[162] *Id.*

including basis. Special rules for basis reduction for income excluded as qualified farm indebtedness are set forth in I.R.C. section 1017(b)(4).

Different rules apply to farmers who receive generic commodity certificates (often called PIK or payment-in-kind certificates) under a government deficiency and diversion program; they must include the face amount of the certificate in income in the year they are received. If a farmer pledges a commodity to the Commodity Credit Corporation (CCC) as security for a loan, the farmer may, under I.R.C. section 77(a), elect to include the face amount of the loan in income. If such an election is made, there is no gain or loss when the loan is repaid. I.R.C. section 1016(a)(8) provides that the basis of property will be adjusted to the extent of income reported. Treas. Reg. section 1.1016-5(e) states that, in a case where property is pledged to the CCC and the face amount of the loan is reported in income, the basis of the property shall be increased by the amount received as a loan and reduced by the amount of any deficiency on such loan to the extent that the taxpayer has been relieved from any liability. To explain how to account these transactions, the IRS issued Revenue Ruling 87-103.[163]

(d) Qualified Real Property Business Indebtedness Exclusion

The Revenue Reconciliation Act of 1993 added new I.R.C. sections 108(a)(1)(D) and 108(c), the qualified real property business indebtedness exclusion. These provisions permit taxpayers other than corporations who own business real estate to defer the tax that would otherwise be payable upon discharge of their indebtedness until they dispose of the related property. More precisely, for a discharge of indebtedness occurring after December 31, 1992, taxpayers (other than C corporations) can elect to exclude from gross income the income from a discharge of qualified real property business indebtedness. Debt is "qualified real property indebtedness" if (1) it was incurred or assumed by the taxpayer in connection with real property used in a trade or business and it is secured by that real property; (2) it was either incurred or assumed before January 1, 1993, or was qualified acquisition indebtedness (generally indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business and secured by that property); and (3) the taxpayer makes the appropriate election to invoke the provision.

The qualified real property business indebtedness exclusion does not apply to the extent the taxpayer is insolvent.[164] Nor is it available for discharge of indebtedness that arises from a title 11 case or a discharge that qualifies for the qualified farm indebtedness exclusion.[165]

The amount excluded as qualified real property business indebtedness under I.R.C. section 108(a)(1)(D) is limited in two ways. First, the exclusion is limited to the amount by which the principal exceeds the fair market value of the property that secures the debt, *less* the outstanding principal of any other qualified real property business indebtedness secured by the same collateral

[163] 1987-2 C.B. 41.
[164] I.R.C. § 108(a)(2)(B).
[165] I.R.C. §§ 108(a)(2)(A); (c)(3)(C).

(a sort of mini-insolvency test).[166] Second, the exclusion may not exceed the aggregate adjusted basis of depreciable real property held by the taxpayer immediately before the discharge.[167]

The amount excluded reduces the basis of the taxpayer's depreciable real property pursuant to I.R.C. section 1017, and thus may affect the basis of both the property securing the debt and other depreciable real property.[168]

The qualified real property business indebtedness exclusion is the only exclusion that is elective. An election to reduce basis of qualified real property must be made on Form 982 (see Exhibit 2.1) with a timely filed (including extensions) federal income tax return for the tax year in which a taxpayer has discharge of indebtedness that is excludible from gross income under section 108(a).[169] This election is revocable with the consent of the Commissioner.[170]

(e) Tax Benefit Rule

The tax benefit rule may interact with the I.R.C. Section 108(a) exclusions. The annual accounting period principle requires a determination of income at the close of each tax year without regard to subsequent events. That is, each tax year is a separate unit for tax accounting purposes. The tax benefit rule is designed to deal with certain subsequent events. Generally, gross income includes the recovery or refund of amounts deducted in an earlier year, unless the taxpayer can demonstrate that there was no tax benefit.[171] The tax benefit rule allows for an exclusion from gross income. Stated another way, the taxpayer excludes from gross income any recovery or refund of an amount that the taxpayer deducted in an earlier year, to the extent the previous deduction did not produce a tax benefit.[172] A taxpayer excludes DOI income by application of the tax benefit rule before applying exclusions from gross income that are provided for under I.R.C. section 108.[173]

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[166] I.R.C. § 108(c)(2)(A), Treas. Reg. § 1.108-6(a).

[167] I.R.C. § 108(c)(2)(B), Treas. Reg. § 1.108-6(b). In determining the aggregate adjusted basis of depreciable real property for this purpose, aggregate basis is first reduced under I.R.C. section 108(b) and (g). Also, the basis of depreciable real property acquired in contemplation of the discharge is not taken into account. I.R.C. § 108(c)(2)(B).

[168] Treas. Reg. § 1.1017-1(c).

[169] Treas. Reg. § 1.108-5(b). *See* Private Letter Ruling 200021014 (Feb. 17, 2000) (granting an extension of time to file an election to reduce basis in depreciable property because the taxpayer's CPA mistakenly believed that the election had to be made at the shareholder level, rather than the S corporation level).

[170] Treas. Reg. § 1.108-5(c)

[171] *See* § 2.3(a)(vi) for a discussion of *Schlifke v. Commissioner* and the tax benefit rule from the perspective of income inclusion. *See* note 351 discussing a Significant Service Center Advice position that the claim of right doctrine does not apply when debt that was treated as discharged is subsequently satisfied.

[172] I.R.C. section 111 provides that gross income does not include income attributable to the recovery during the tax year of any amount deducted in any prior year to the extent such amount did not reduce tax imposed under Chapter 1 of the I.R.C. A detailed discussion of what may be excluded from gross income is beyond the scope of this treatise.

[173] *See* Rev. Rul. 67-200, 1967-1 C.B. 15, *clarified by* Rev. Rul. 70-406, 1970-2 C.B. 16.

The interaction of the I.R.C. section 108 exclusions and the tax benefit rule exclusion may be illustrated by example. An accrual-method taxpayer borrows $100 from an unrelated creditor, deducts $10 in interest expense, but never pays interest or principal on the debt. The $10 interest expense deduction generates a net operating loss for the taxpayer, but the net operating loss expires before the taxpayer can use it to offset other taxable income. That is, the deduction of the interest did not create a tax benefit for the taxpayer. Later, the creditor forgives the debt. The tax benefit rule applies first, and the taxpayer can exclude from gross income the recovery of the interest, equal to the amount that the taxpayer deducted in an earlier year ($10) because it did not produce a tax benefit. The tax benefit rule does not apply to the $100 of principal forgiven because it was not deducted in an earlier year. The discharge of indebtedness rules apply to the $100, and it may be excluded to the extent permitted under I.R.C. section 108, subject to attribute reduction as discussed in § 2.7(a).

§ 2.7 CONSEQUENCES OF QUALIFYING FOR SECTION 108(a) EXCLUSIONS

(a) Attribute Reduction

Although certain DOI income may be excluded from income, I.R.C. section 108(b)(2) provides that the price for such exclusion is tax attribute reduction. For DOI income excluded under the title 11 exclusion, the insolvency exclusion, or the qualified farm indebtedness exclusion (but not the qualified real property business exclusion), the following tax attributes of the taxpayer[174] must be reduced, in the order listed:

- Net operating losses. Any net operating loss for the tax year of discharge and any net operating loss carryover to the tax year of discharge.
- General business credit. Any carryover to or from the tax year of discharge of a credit under I.R.C. section 38.
- Minimum tax credit. Any minimum tax credit available under section 53(b) at the beginning of the tax year immediately after discharge.
- Capital loss carryovers. Any capital loss for the tax year of the discharge and any capital loss carryover to the tax year of discharge under I.R.C. section 1212.
- Basis reduction. The debtor's property reduced according to the provisions of I.R.C. section 1017.
- Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the tax year of the discharge.

[174] The taxpayer is usually the debtor for purposes of attribute reduction, and those terms are used interchangeably in this treatise. However, the estate may be the taxpayer if the debtor is an individual in a title 11 case. I.R.C. § 108(d)(8). Attribute reduction for a debtor that is a member of a consolidated group is discussed in § 2.9(a).

- Foreign tax credit carryovers. Any carryover to or from the tax year of discharge of the credit allowed under I.R.C. section 33.[175]

Each tax attribute category, except for basis reduction, must be reduced to zero before any reductions in the next category are made. For insolvency or title 11 situations, the reduction to basis is required only to the extent that the basis of the taxpayer's assets exceeds the amount of liabilities immediately after discharge.[176] After the net operating loss has been reduced to zero, any balance remaining is first applied against the business credit carryover, and so forth. If all attributes are reduced to zero (and basis is reduced to an amount equal to post-discharge liabilities), any amount of DOI income that remains is completely discharged. It is not included in income and future tax attributes are not reduced. In most cases, however, the reduction of tax attributes defers rather than eliminates the tax on income from debt discharge.

As an alternative to this order for attribute reduction, the debtor can elect to reduce the basis of depreciable property before the other tax attributes. The basis reduction election is discussed in detail in § 2.7(d)(i).

I.R.C. section 108(b)(4)(A) provides that the reduction in attributes is made after income is computed for the year in which the discharge occurs. Recall that in an out-of-court case, the gain from debt discharge where the debtor is solvent, or to the extent that the debtor becomes solvent, is DOI income. Thus, the income from debt discharge (that is not excluded from income under section 108(a)) as well as other income arising from other activities that occur in the year a debt is discharged are offset by the debtor's net operating loss carryovers and other attributes prior to reducing those attributes due to excluded DOI income under I.R.C. section 108(b). In addition, any remaining income can be reduced by a net operating loss carryover to that year. I.R.C. section 108(b)(4)(B) also provides that reductions to net operating losses or capital losses are first made to losses arising in the tax year of the discharge and then to carryovers to such year in the order of the tax years from which each carryover arose.

Next, consider an example that shows how attribute reduction is computed. X Corporation has assets with a value of $1,000 and liabilities of $1,200. The only tax attributes of X are a net operating loss carryover of $400 and an asset basis of $100. In a workout outside of bankruptcy, all the creditors receive long-term debt with a face amount and issue price of $700. The reduction of debt ($500) is excluded to the extent of the prior insolvency ($200), and the balance ($300) is DOI income includable in gross income. That income (along with any operating income for the year) can be offset by the net operating loss carryover (reducing the carryover to $100). The debt reduction that was excluded from income due to the insolvency exclusion ($200) is then applied against the tax attributes, thereby eliminating the $100 loss carryover. The basis of assets is then reduced by $100.

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[175] This order of attribute reduction applies only for income excluded under I.R.C. section 108(a)(1)(A) (title 11), (B) (insolvency), and (C) (qualified farm indebtedness). Income excluded by taxpayer election under I.R.C. section 108(a)(1)(D) (qualified real property business indebtedness) is treated as a reduction in the basis to the taxpayer's depreciable property pursuant to I.R.C. section 1017, which is discussed at § 2.7(d)(ii)(D).

[176] I.R.C. section 1017(b)(2).

If the discharge occurred pursuant to bankruptcy proceedings, then the exclusion of DOI income would not be limited to the extent of X's insolvency. Nevertheless, tax attributes, including the loss carryover and basis, would be reduced to the extent of the $500 excluded DOI income.

In a workout outside of bankruptcy, the timing of the debt discharge is important. In the following example, the debt is reduced in the same amount as the previous example, but in different tax years and with different tax consequences. Assume the same facts as in the last example, except that $400 of debt was cancelled in Year 1 and the balance of $100 was cancelled in Year 2. Under these conditions, in Year 1, X Corporation would have DOI income excluded to the extent of prior insolvency of $200. The balance of $200 of DOI income can be offset by the $400 net operating loss carryover. X Corporation will reduce tax attributes by the $200 of excluded DOI income, using up all the net operating loss carryover. In Year 2, the $100 of income from the discharge of indebtedness will be taxed because there is no net operating loss left to reduce. X Corporation could have elected to reduce the basis of depreciable property first and left the net operating loss for use in Year 2. If X Corporation was in bankruptcy, this problem would not exist.

(b) Net Operating Loss Reduction

Before a net operating loss or net operating loss carryover can be reduced under I.R.C. section 108(b), a debtor must consider the impact, if any, of other I.R.C. provisions on the amount or availability of that net operating loss.

(i) Net Operating Loss Reduction and Carrybacks

Ordering and timing issues abound when tax attributes are reduced as the price for excluding DOI income from gross income. One ordering conflict is between I.R.C. section 108(b) reduction of tax attributes and the carryback of those tax attributes to prior tax years. Net operating losses may be carried back, that is, applied to previous tax years. The use of a net operating loss for any tax year (the loss year) to offset taxable income of other tax years is limited to a period of tax years before the loss year (the carryback period) and a period of tax years after the loss year (the carryover period). The carryback and carryover periods determine the maximum number of tax years in which a taxpayer may offset taxable income with any particular net operating loss. The current general rule for corporations provides a two-year carryback period and a 20-year carryover period; provided, however, that a five-year carryback period applies for net operating losses for tax years ending during 2001 or 2002.[177]

The ordering rule of I.R.C. section 108(b)(4)(A) states that tax attribute reduction is made after tax liability is determined for the year in which the DOI income occurred. The I.R.C. does not address how the carryback of tax attributes fits into this sequence. One question is *ordering*, whether a net operating loss (or other tax attribute subject to carryback) that occurs in the same tax year as the discharge is first reduced under I.R.C. section 108(b) or is first carried back to

[177] I.R.C. § 172(b)(1)(A), (H).

another tax year. Regulations issued in 2003 resolved this question for discharges of indebtedness occurring after July 17, 2003; the uncertainty remains, however, for prior discharges. For post-July 17, 2003 discharges, tax attributes that are carryovers to the discharge year or that may be carried back to the pre-discharge years are taken into account by the taxpayer before attributes are reduced under I.R.C. 108(b).[178] Another open issue is the *timing* of attribute reductions, that is, whether the reductions are made in the tax year of the discharge or in the next tax year.

With regard to the timing issue, the I.R.C. does not specifically address when tax attributes are reduced (with the exception of basis reduction). Does the reduction occur as the last event in the year of the discharge or as the first event in the year following the discharge? Unlike the other tax attributes subject to reduction, the timing of basis reduction at first blush appears clear. I.R.C. section 1017(a) provides that basis reduction occurs at the beginning of the year following the year of the discharge.[179] There is no companion rule provided for other tax attributes, including net operating loss. If the net operating loss reduction occurred at the same time as basis reduction, then the net operating loss would be available in the year of discharge to be carried back to another year.

Prior to the issuance of the treasury regulations, the Supreme Court considered the order of tax attribute reduction under section 108 and the taxation of shareholders in an S corporation in *Gitlitz v. Commissioner*.[180] The case supports ordering tax attribute reduction after the carryback of attributes in line with the regulations, but may not shed much light on the timing issue. As discussed in greater detail in § 3.3(e), the Supreme Court held that although DOI income of an insolvent taxpayer is not included in gross income, it is nevertheless an item of income that passes through to the S corporation shareholders. Having determined that the DOI income passes through to the shareholders, the Supreme Court held that the passthrough occurs before the tax attribute reduction. The Supreme Court found that the "[t]he sequencing question is expressly addressed in the statute. Section 108(b)(4)(A) directs that the attribute reductions 'shall be made *after* the determination of *tax imposed* by this chapter for the tax year of the discharge.' (Emphases added.) See also Section 1017(a) (applying the same sequencing rules when Section 108 attribute reduction affects basis of corporate property)."[181] Broadly read, this language could equate the general attribute reduction with the next-year basis reduction rule. However, the Supreme Court seems to address the *ordering* of attribute reduction as opposed to the *timing* of attribute reduction. That is, it does not appear that the Supreme Court's ultimate decision was based on whether a suspended loss is reduced as the last event in the tax year of the discharge or as the first event in the following tax year.

Cases that preceded the Supreme Court's decision in *Gitlitz* did address the timing issue, but those cases reached conflicting results. The Third Circuit held

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[178] Treas. Reg. § 1.108-7T(b).

[179] But see § 5.8(b) providing in I.R.C. section 381(a) transaction the basis of property includes reduction.

[180] 531 U.S. 206, 218 (2001).

[181] *Id*. at 218.

that all tax attributes were reduced on the first day of the year following the year of discharge.[182] Conversely, the Tenth Circuit, the Sixth Circuit, and the Tax Court held that tax attributes (except basis) were reduced at the end of the year of discharge.[183] Although the Supreme Court's decision in *Gitlitz* could be read to support this position, the Tenth and Sixth Circuit cases were overruled by *Gitlitz* on other issues. The differing views of the circuit courts on the timing issue, coupled with the lack of clear guidance by the Supreme Court have left this issue in flux.

It is implicit in a consolidated return regulation example of discharge of indebtedness that the reduction in net operating loss occurs in the year of discharge, rather than on the first day of the following tax year.[184] Caution should be used in relying on this regulation outside the consolidated return context to argue that the attribute reduction occurs on the last day of the discharge year, especially in light of the contradictory judicial authority. The case law, statutes, and administrative guidance on the timing issue are far from examples of judicial, legislative, or administrative clarity.

Temporary regulations clarify the ordering issue for discharges occurring after July 17, 2003 that the carrybacks to pre-discharge years occur before I.R.C. section 108(b) attribute reduction. For discharges that occurred before the effective date of the temporary regulations, it is also arguable that the carrybacks occur before the attribute reduction (other than basis) on the premise that carrybacks may affect tax liability for the year. That is, attribute reduction occurs after the determination of tax for the tax year of the discharge and there are circumstances in which the carryback could affect the computation of tax liability for the year of discharge. For instance, note the items of ordinary income, ordinary loss, capital gain, and capital loss for corporation X in years 1 through 5.

Tax Year	1	2	3	4	5
Ordinary Income (Loss)	($100 Loss)		$100 Income		($100 Loss)
Capital Gain (Loss)		$100 Gain	($100 Loss)	$100 Gain	

Assume that in Year 3 there is also $100 of excluded discharge of indebtedness income that may reduce the $100 capital loss. Further assume that the $100 ordinary loss generated in Year 1 has been carried over to offset the capital gain in Year 2.

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[182] *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000); *Hogue v. United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 50149 (D. Ore. 2000). *See also Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), *vacated and remanded*, 2001-1 U.S. Tax Cas. (CCH) ¶ 50339.

[183] *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *rev'd*, 531 U.S. 206 (2001); *Guadiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000), *overruled in part*, *Gitlitz v. Commissioner*, 531 U.S. 206 (2001); *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (1999), *overruled in part*, *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

[184] Example 4, Treas. Reg. section 1.1502-32(b)(5) involves an insolvent subsidiary whose net operating loss is reduced under I.R.C. section 108(b) at the close of the tax year of the discharge.

The $100 capital loss generated in Year 3 cannot be used to offset the Year 3 $100 of ordinary income. If the Year 3 $100 capital loss is carried back to offset the $100 of capital gain in Year 2, the Year 1 $100 ordinary loss would be freed up and carried over to offset $100 ordinary income in Year 3. Therefore, the carryback of the capital loss impacts the computation of tax imposed in the year of the discharge and should be permitted prior to attribute reduction. This begs the question: does a taxpayer need to be in a situation in which the carryback actually impacts the computation of tax in the year of discharge? Given this example and no indication in the legislative history to the Bankruptcy Tax Act of 1980 to the contrary, it is reasonable to conclude that a carryback of a net operating loss or other enumerated item should be permitted prior to attribute reduction regardless of whether the carryback actually impacts that year's tax liability.

Even this argument is not conclusive, however. Returning to the example, the Year 5 $100 ordinary loss may be carried back to offset the Year 4 $100 capital gain. If the Year 3 $100 capital loss is carried forward to offset the Year 4 $100 capital gain, then the Year 5 $100 ordinary loss may be carried back to offset the Year 3 $100 of ordinary income. Therefore, the carryover of the Year 3 capital loss affects the computation of tax liability for Year 3. It would be difficult to argue that a loss may be carried over prior to being reduced, even if it impacts current year tax liability.

As shown by this exercise, the absence of clear guidance renders this issue susceptible to varying interpretations for time periods not covered by the temporary regulations.

(ii) Net Operating Loss Carryover Calculation

How net operating loss carryover is calculated is beyond the scope of this section. It is interesting to note, however, that a taxpayer may correct its earlier mistakes to recalculate net operating carryover to a current year. This is an option, even if the mistake occurred in a closed tax year, that is, a year for which the statute of limitations has expired. Once the statute of limitations has run for a year, the taxpayer cannot redetermine its net operating loss for that year. Nevertheless, the IRS has taken the position that a taxpayer may correct a mistake in a closed tax year to recalculate the net operating loss carryover to an open tax year.

That position was taken in a Private Letter Ruling.[185] In that ruling, the debtor's plan of reorganization in a title 11 case was confirmed in Year 1. The debtor's income tax return for that year showed DOI income that was completely offset by the debtor's net operating losses under I.R.C. section 108(b). After the statute of limitations for filing an amended return for Year 1 expired, the debtor claimed that it had made a mistake in Year 1 that affected its net operating loss carryover for a later (open) tax year. The debtor claimed that it did not have a cancellation of debt in Year 1, hence no DOI income, and that it should not have reduced its net operating losses in Year 1. The IRS allowed the debtor to recalculate the net operating loss carryover to correct the mistake in the closed year because the tax year that was affected by the net operating loss carryover was still open.

[185] Private Letter Ruling 9504032 (Oct. 31, 1994).

(iii) Interaction with Section 382(l)(5)

I.R.C. section 382, which is discussed in detail in Chapter 6, limits the usefulness of a corporation's net operating losses following certain ownership changes. In general, that section determines how certain tax attributes, including net operating loss carryovers, are used following an ownership change of a loss corporation. An ownership change occurs when the percentage of stock held by one or more 5-percent shareholders of a loss corporation on a testing date has increased by more than 50 percentage points over the lowest stock ownership held by such shareholders during a testing period (usually a three-year period).[186] The terminology of I.R.C. section 382, such as "ownership change, "5-percent shareholder," and "loss corporation" will be discussed in Chapter 6.

Generally, when an ownership change occurs, I.R.C. section 382(a) limits the amount of post-ownership-change taxable income that can be offset by pre-ownership-change losses. I.R.C. section 382(a) limits the usefulness of net operating losses and net operating loss carryovers, but does not reduce the dollar amount of those items. Net operating losses and net operating loss carryovers may be reduced under I.R.C. section 108(b), even if their use is limited by I.R.C. section 382(a).

If the special bankruptcy rule of I.R.C. section 382(l)(5) applies, the losses are actually *reduced*. That provision is an exception to the general rule of I.R.C. section 382 that limits the use of, but does not reduce, net operating losses and net operating loss carryovers. For the exception to apply, the certain conditions must exist. One of those requirements is that the corporation had an ownership change while in a title 11 case. If the I.R.C. section 382(l)(5) exception applies to an ownership change, the corporation suffers no limitation on the use of its pre-ownership-change tax attributes. However, the corporation may be required to reduce its tax attributes, including net operating losses and net operating loss carryovers under I.R.C. section 382(l)(5)(B).

Thus, both I.R.C. section 382(l)(5) and I.R.C. section 108(b) impact net operating losses and net operating loss carryovers. But which code section is applied first? The better answer seems to be that I.R.C. section 382(l)(5) applies first. If losses occurring in the year of the discharge or net operating loss carryovers are reduced by section 382(l)(5)(B) first, then less net operating loss will be available for tax attribute reduction purposes under I.R.C. section 108(b).[187] The I.R.C. section 382 reduction to net operating losses and net operating loss carryovers should probably occur before the I.R.C. section 108(b) tax attribute reduction for three reasons.

1. The word "reduction" is somewhat of a misnomer with respect to I.R.C. section 382(l)(5)(B). This provision requires that losses be *computed* as if no deduction was allowed for certain interest paid or accrued. Although the title of I.R.C. section 382(l)(5)(B) is a "Reduction For Interest Pay-

[186] I.R.C. § 382(g).

[187] For a discussion of the relationship between DOI income and the built-in gain amount under I.R.C. section 382, see § 6.4(h).

ments . . . ," its operative language provides that certain interest is simply not included in computing a net operating loss or net operating loss carryover. I.R.C. section 382(l)(5)(B) provides that if the exception applies, the pre-ownership-change losses and excess credits that may be carried to a post-ownership-change year are computed as if no deduction was allowable for interest paid or accrued for debt that is converted to stock during the three-year period preceding the tax year in which the ownership change occurs and for the period in the tax year of the ownership change on or before the ownership change date. The exclusion of these amounts should precede an actual reduction to a net operating loss or net operating loss carryover under I.R.C. section 108(b).

2. The I.R.C. section 382 regime takes priority over the I.R.C. section 108 discharge of indebtedness rules for stock-for-debt discharge of indebtedness, which indicates that it would take precedence in other situations.

3. Net operating loss and net operating loss carryover reductions under I.R.C. section 108(b)(4)(A) are made after tax for the tax year of the discharge. Assuming this language requires all items affecting tax to be determined prior to I.R.C. section 108(b) reduction, the exclusion of certain interest items under I.R.C. section 382(l)(5) would precede the attribute reduction.

The interaction between these Code sections is complicated. For stock-for-debt DOI income under I.R.C. section 108(e)(8), I.R.C. section 382(l)(5)(C) specifically provides that the debt discharged does not include the portion of the debt arising from interest. Keeping this rule in mind, consider the following example.

During the course of title 11 bankruptcy proceedings, X corporation satisfies $11,000 of its debt with $6,000 of newly issued X corporation stock. This transaction is an ownership change that qualifies for the I.R.C. section 382(l)(5) exception, so net operating loss carryovers are reduced. X corporation has $3,000 of net operating loss carryovers. $1,000 of this carryover is attributable to interest deductions on the debt. X corporation also has assets with a $6,000 basis. Under I.R.C. section 382(l)(5)(B), the pre-ownership-change losses are computed as if the interest expense deduction of $1,000 was not allowed, so X corporation reduces its net operating loss from $3,000 to $2,000.

X corporation next calculates DOI income. I.R.C. section 382(l)(5)(C) provides that the "disallowed" interest expense will not be taken into account for purposes of calculating stock-for-debt DOI income. X corporation has $4,000 DOI income computed as follows: $10,000 debt (amount of debt without the $1,000 of debt attributable to the interest deductions per I.R.C. section 382(l)(5)(C)) less the fair market value of stock used to satisfy the debt of $6,000. Because X corporation is in title 11 proceedings, the $4,000 DOI income is excluded from its gross income, but attributes are subject to reduction. X corporation reduces its recomputed net operating loss carryover of $2,000 to zero and its basis in assets of $6,000 by $2,000 to $3,000, for a total I.R.C. section 108(b) attribute reduction of $4,000.

(c) Credit Carryover Issues

When tax attributes are reduced, the amount of the reduction varies according to which attribute is affected. The general business credit, the minimum tax credit, the passive activity credit, and the foreign tax credit carryovers are reduced by 33-cents for each dollar of DOI income excluded.[188] All other reductions are dollar-for-dollar.[189] This makes sense because a tax credit differs from a deduction. The deduction lowers the amount of income subject to taxation; the credit lowers the amount of tax due. Thus, the overall economic effect of lowering a deduction by $100 may be the same as a $33 reduction in a tax credit.

As discussed above, the reductions are made after the determination of tax for the year of discharge. Thus, the debtor is given one more opportunity to absorb any net operating loss, capital loss, or credit carryovers, if income was earned in the year the debt is discharged. For net operating and capital losses, the reductions must be made first from the losses for the tax year and then from the loss carryovers in the order of the tax years for which the losses arose. The reduction of tax credits is to be made in the order the carryovers are taken into account for the tax year of the discharge.[190] In determining the amount of the reduction under I.R.C. section 108(b)(1), any limitation on the use of credits based on the income of the debtor is disregarded.[191]

(d) Basis Reduction

The exclusion of DOI income for bankruptcy or insolvency results in a reduction to the basis of property in one of two ways – as the fifth tax attribute reduced under the I.R.C. section 108(b)(2)(E) general ordering rules or as the first tax attribute reduced pursuant to the I.R.C. section 108(b)(5) basis reduction election. If net operating losses, general business credits, minimum tax credits, and capital loss carryovers do not fully absorb the reductions required to offset the DOI income excluded from gross income under I.R.C. section 108(a), then the debtor must reduce the basis of assets. Rather than following the standard attribute reduction order, the debtor can elect to reduce basis in depreciable property first. I.R.C. section 1017 and the regulations generally govern basis reduction, specifying the manner and timing of reductions to asset basis.[192]

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[188] For tax-attributed reductions before January 1, 1987, credit carryovers were reduced at the rate of 50 cents for each dollar of debt discharged.

[189] I.R.C. § 108(b)(3)(A).

[190] I.R.C. § 108(b)(4).

[191] S. Rep. No. 1035, 96th Cong., 2d Sess. 13 (1980). Prior to the Tax Reform Act of 1984, I.R.C. section 108(b)(2)(B) provided a different list of credit carryovers subject to reduction that became obsolete due to the combination of certain credits into a general business credit.

[192] Treas. Reg. section 1.1017-1 is effective on or after October 22, 1998. Treas. Reg. § 1.1017-1(i). For previous rules regarding basis reduction see former Treas. Reg. sections 1.1016-7 and 1.1017-2 that were promulgated in 1957 and 1956, respectively.

(i) Basis Reduction Election

The order of tax attribute reduction is altered if the debtor makes a basis reduction election under I.R.C. section 108(b)(5). The basis reduction election allows a debtor to first apply any portion of the attribute reduction required due to debt discharge to reduce the basis of *depreciable property*.[193] Depreciable property is defined as any property of a character subject to the allowance for depreciation, but only if the basis reduction will reduce the amount of depreciation or amortization that otherwise would be allowed for the period immediately following the reduction.[194] It would appear that property subject to depletion is included in this definition. A debtor may elect to treat any real property held primarily for sale to customers in the ordinary course of business as depreciable property.[195] A debtor may elect to treat stock of another member of a consolidated group or partnership interest as depreciable property under certain circumstances, generally if the corporation or partnership owns depreciable property and consents to the election.[196]

The basis reduction election is an option if the DOI income is excluded due to a title 11 case, insolvency, or qualified farm indebtedness. The election is not available for qualified real property business indebtedness.

If no basis reduction election is made in a title 11 or insolvency situation, I.R.C. section 1017(b)(2) provides that the reduction to basis is required only to the extent that the basis of assets exceeds the amount of the liabilities immediately after discharge. Although this rule does not apply if the debtor makes the basis reduction election, another rule applies—the amount to which the election applies cannot exceed the aggregate adjusted basis of depreciable property held by the debtor as of the beginning of the first tax year subsequent to the tax year of discharge.

(A) Election Procedures

To make an election under section 108(b)(5), a Form 982 *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)* must be completed and attached to a timely filed (including extensions) federal income tax return for the tax year in which DOI income is excluded from income. If the taxpayer establishes to the satisfaction of the Commissioner reasonable cause for failure to file the election with the taxpayer's original return, the taxpayer may file the election with an amended return or a claim for credit or refund.[197]

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[193] Implicit in this rule is that debtor can make an I.R.C. section 108(b)(5) election to the extent the debtor chooses. It is not mandatory to make this election to the extent of the full discharge of indebtedness or to the entire amount of the debtor's basis in depreciable property. *See* Treas. Reg. § 1.1017-1(c)(2).

[194] I.R.C. § 1017(b)(3)(B). The basis reduction is not limited to the amount of depreciation or amortization for the subsequent period, however.

[195] I.R.C. § 1017(b)(3)(E).

[196] *See* §§ 2.7(d)(ii)(E), (F), 2.9(a).

[197] *See*, *e.g.*, Private Letter Ruling 9406015 (Nov. 12, 1993); Private Letter Ruling 9150033 (Sept. 13, 1991) (taxpayer demonstrated good cause for not filing elections to reduce basis due to uncertainty of pending request for private letter ruling).

EXHIBIT 2.1

IRS Form 982 and Instructions (Rev. September 2000)

Form **982**
(Rev. September 2000)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ **Attach this form to your income tax return.**

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return | **Identifying number**

Part I General Information (see instructions)

1 Amount excluded is due to (check applicable box(es)):
a Discharge of indebtedness in a title 11 case ☐
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☐
c Discharge of qualified farm indebtedness ☐
d Discharge of qualified real property business indebtedness ☐
2 Total amount of discharged indebtedness excluded from gross income . . . 2
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☐ Yes ☐ No

Part II Reduction of Tax Attributes (You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements.)

Enter amount excluded from gross income:

4 For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property . . . 4
5 That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property . . . 5
6 Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge . . . 6
7 Applied to reduce any general business credit carryover to or from the tax year of the discharge 7
8 Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge . . . 8
9 Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge . . . 9
10 Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness* . . . 10
11 For a discharge of qualified farm indebtedness, applied to reduce the basis of:
a Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5 . . . 11a
b Land used or held for use in a trade or business of farming . . . 11b
c Other property used or held for use in a trade or business, or for the production of income . . . 11c
12 Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge 12
13 Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge . . . 13

Part III Consent of Corporation to Adjustment of Basis of its Property Under Section 1082(a)(2)

Under section 1081(b), the corporation named above has excluded $ .... from its gross income for the tax year beginning ...., and ending .... Under that section the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ....
(State of incorporation)

Note: *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

The election may be revoked only with the consent of the Commissioner.[198] In Private Letter Rulings,[199] the IRS allowed S corporations to revoke I.R.C. section 108(b)(5) elections that were made shortly before the Supreme Court issued *Gitlitz v. Commissioner*,[200] reversing decisions of the Tax Court and the Tenth Circuit Court of Appeals. The S corporations requested revocation of the elections within two months after the *Gitlitz* decision was issued, because the basis reduction elections would not have been made if the law, as decided in *Gitlitz*, had been clear at the time the elections were made. The IRS allowed the S corporations to revoke the basis reduction elections because each taxpayer "acted reasonably and in good faith" such that granting relief would not prejudice the interests of the government.

(B) Basis Adjustment of Individual's Estate

I.R.C. section 108(c)(7) provides that the basis adjustments, along with other attribute reductions due to debt discharge, are to be made by the estate as the taxpayer and not the individual. Thus, the election to reduce depreciable property and not tax attributes will be made by the trustee or debtor-in-possession. Basis adjustment is to be made as of the first day of the tax year following the discharge. For example, assume an estate files its final return for a period ending on September 15, 20X6, and basis adjustment is required. Should the individual reduce property as of September 16, 20X6—the beginning of a new tax year of the estate if it was required to file a return—or January 1, 20X7, the first day of the individual's tax year? A Senate Report[201] indicated that if basis reduction is required due to debt discharge in the final year of the bankruptcy estate, the reduction is to be made in the basis of assets acquired by the debtor from the estate and at the time acquired. Thus, in the example above, it would appear that the basis should be reduced as of September 16, 20X6, and cannot include reduction of other property held by the debtor on September 16, 20X6. I.R.C. section 1017(c)(1) specifically states that basis of exempt property cannot be reduced. See Chapter 4 for additional information related to the tax impact of an individual's estate.

(ii) Basis Reduction Rules

(A) Title 11 and Insolvency

If the basis reduction election is not made, recall that for insolvency and title 11 case exclusions, under the I.R.C. section 1017(b)(2) rule, basis reduction is limited to the excess of the aggregate basis of property and money held by the taxpayer over the liabilities of the taxpayer immediately after the discharge. For basis reduction that results from income excluded under the insolvency or title 11 exclusions (and no basis reduction election is made) Treas. Reg. section

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[198] Treas. Reg. § 1.108-4(b).

[199] Private Letter Ruling 200210044 (Dec. 6, 2001); Private Letter Ruling 200208016 (Nov. 21, 2001).

[200] 531 U.S. 206 (2001), *rev'g*, 183 F.3d 1143 (10th Cir. 1999). For a discussion of the *Gitlitz* decision, *see* §§ 2.7(b)(i)(A) and 3.3(e).

[201] S. Rep. No. 1035, 96th Cong., 2d Sess. 14 (1980).

1.1017-1(a) provides that the reduction of basis of specified assets must be made in the following order (in proportion to adjusted basis):

- Real property used in a trade or business or held for investment (other than real property included as inventory or held primarily for sale to customers in the ordinary course of business) that *secured* the discharged debt immediately before the discharge;
- Personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that *secured* the discharged debt immediately before the discharge;
- Other property used in a trade or business or held from investment (other than inventory, accounts receivable, notes receivable, and real property included as inventory or held primarily for sale to customers in the ordinary course of business);
- Inventory, accounts receivable, notes receivable, and real property included as inventory or held primarily for sale to customers in the ordinary course of business; and
- Property neither used in a trade or business nor held for investment.

The regulations include an anti-abuse rule that disregards changes to property securing debt made within the year preceding the discharge if a principal purpose of the change is to affect basis reduction.[202]

(B) Basis Reduction Election

As discussed in § 2.7(d)(i), if a basis reduction election is made, the basis of depreciable property is reduced before any other tax attribute. A taxpayer who makes a basis reduction election under I.R.C. section 108(b)(5) may make a second election to treat any real property held primarily for sale to customers in the ordinary course of business as depreciable property.[203] The taxpayer may also make other elections to treat corporate stock or partnership interest as depreciable property under certain circumstances.[204]

Treas. Reg. section 1.1017-1(c) modifies the order of attribute reduction described in § 2.7(d)(ii) for a debtor who makes a basis reduction election. The debtor may reduce the basis of *depreciable property* in the following order:

- Real property used in a trade or business or held for investment (other than real property included as inventory or held primarily for sale to customers in the ordinary course of business) that *secured* the discharged debt immediately before the discharge.
- Personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that *secured* the discharged debt immediately before the discharge.

[202] Treas. Reg. § 1.1017-1(d).

[203] I.R.C. §§ 1017(b)(3)(E), (4)(C); Treas. Reg. § 1.1017-1(f). Neither the I.R.C. section 108(b)(5) basis reduction election nor the I.R.C. section 1017(b)(3)(E) depreciable property election is available for the qualified real property business indebtedness exclusion.

[204] *See* §§ 2.7(d)(ii)(E)-(F); 2.9(a)(i).

- Other property used in a trade or business or held from investment (other than inventory, accounts receivable, notes receivable, and real property included as inventory or held primarily for sale to customers in the ordinary course of business).
- If the debtor makes a second election to treat real property included as inventory or held primarily for sale to customers in the ordinary course of business as depreciable property, then the basis of that property is reduced next.

Excluded DOI income in excess of the basis reductions to depreciable property must be applied to reduce the other tax attributes according to the general ordering rules of I.R.C. 108(b)(2) starting with net operating losses, if any. The tax attributes reduced may include the basis in property that is not depreciable. In this situation, the rule that limits basis reductions to post-discharge liabilities for title 11 and insolvency situations is modified. That is, if the basis of a debtor's assets is reduced by $100 pursuant to a basis reduction election, the aggregate asset basis of the debtor, for purposes of I.R.C. section 1017(b)(2), would be reduced by $100.[205]

(C) Qualified Farm Indebtedness

Special rules apply for qualified farm indebtedness.[206] If DOI income is excluded as qualified farm debt (and a basis reduction election is not made), then the debtor must reduce tax attributes according to the general ordering rule of I.R.C. section 108(b)(2).[207] Only the basis of "qualified property" (property used or held for use in a trade or business or for the production of income) is reduced. Qualified property is reduced in the following order: depreciable property, land used for farming, and other qualified property.

The first type of qualified property eligible for basis reduction to offset income attributable to the discharge of qualified farm indebtedness is depreciable property. Like a debtor who makes a basis reduction election, a debtor who must reduce tax attributes as a result of qualified farm indebtedness may elect to treat real property that is inventory or is held primarily for sale to customers in the ordinary course of business as depreciable property.[208] Under the right circumstances, the debtor may be able to elect to treat corporate stock or partnership interest as depreciable property.[209] The basis reduction election of I.R.C. 108(b)(5) is also an option for the debtor.

(D) Qualified Real Property Business Indebtedness

The general ordering rules for attribute reduction under I.R.C. 108(b) are not applicable to the qualified real property business indebtedness exclusion.[210] This

[205] Treas. Reg. § 1.1017-1(c)(3).
[206] I.R.C. § 1017(b)(4).
[207] For a discussion of the qualified farm indebtedness exclusion, see § 2.6(d).
[208] I.R.C. §§ 1017(b)(3)(E), (4)(C); Treas. Reg. § 1.1017-1(f).
[209] I.R.C. §§ 1017(b)(4)(C); *see* §§ 2.7(d)(ii)(E)-(G); 2.9(a)(i).
[210] Because basis is the only tax attribute affected in this situation, the basis reduction election does not apply.

is the only elective exclusion and if the debtor opts to exclude DOI income under the qualified real property business indebtedness exclusion, then the debtor must reduce the basis of depreciable real property.[211] The basis reduction order described in § 2.7(d)(ii)(A) is modified in this situation.[212] The basis of "qualifying real property" is reduced before the basis of other depreciable real property is reduced. Qualifying real property is generally the real property underlying the qualified real property business indebtedness.

An election under I.R.C. section 1017(b)(3)(E) to treat any real property held primarily for sale to customers in the ordinary course of business as depreciable property is not available for basis reductions due to qualified real property business indebtedness.[213] Under the right circumstances, however, the taxpayer may elect to treat depreciable real property of a partnership as depreciable real property subject to basis reduction.[214]

(E) Depreciable Property Held by Partnership

The debtor who excludes DOI income may own an interest in a partnership that holds depreciable property. The partnership interest may be treated as depreciable property to the extent of the debtor-partner's proportionate interest in the depreciable property held by the partnership. This treatment is only available for basis reduction of depreciable property following a basis reduction election or in a qualified real property business indebtedness setting.[215]

This special rule may be applied only if there is a corresponding reduction in the basis of the partnership's depreciable property ("inside basis"). The regulations generally allow the partner to choose whether to ask the partnership to reduce the partner's share of depreciable partnership property and also generally allow the partnership the right to grant or deny the request in its sole discretion. A partnership must consent to make appropriate reductions in a partner's share of inside basis, however, if requested by (i) partners owning, directly or indirectly, a greater-than-80-percent capital and profits interest of the partnership or (ii) five or fewer partners owning, directly or indirectly, more than 50 percent of the capital and profits interests of the partnership. The regulations require a "consenting" partnership to provide the partners with a "Partnership Consent Statement" on or before the partnership files its Form 1065, and require the partner to attach a copy of the statement to its federal income tax return for the tax year in which the taxpayer has DOI income that is excluded from gross income under I.R.C. section 108(a).[216]

(F) Depreciable Property Held by Corporation

As discussed in § 2.9(i), consolidated group members may elect flow-through treatment for depreciable property owned by a lower-tier member of

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[211] For a discussion of the qualified real property business indebtedness exclusion, *see* § 2.6(d).
[212] Treas. Reg. § 1.1017-1(c)(1).
[213] I.R.C. § 1017(b)(3)(F)(ii); Treas. Reg. § 1.1017-1(f).
[214] I.R.C. §§ 1017(b)(3)(F)(i); Treas. Reg. § 1.1017-1(g).
[215] I.R.C. § 1017(b)(3)(C); Treas. Reg. § 1.1017-1(g)(2)(i).
[216] Treas. Reg. § 1.1017-1(g)(2)(ii).

the group. I.R.C. section 1017(b)(3)(D) provides that a parent corporation's investment in the stock of its subsidiary shall be treated as depreciable property to the extent that the subsidiary agrees to reduce the basis of its depreciable property. This election is not limited to a single tier; it may be used by a chain of corporations, provided the lowest-tier subsidiary reduces the basis in its depreciable property.

(G) Multiple Debt Discharges

The debtor often has more than one debt discharged. The regulations provide that, if the DOI income is attributable to the cancellation of more than one debt, the basis reductions will be applied in proportion to the DOI income attributable to each discharged debt.[217] For example, assume a debtor excludes $100 of DOI income from gross income ($20 from a secured debt and $80 from an unsecured debt). $40 of the DOI income (i.e., 40 percent) results in the reduction of net operating losses, general business credits, minimum tax credits, and capital loss carryovers, and the other 60 percent is used to reduce basis. The debtor must apply the basis reduction rules, allocating $12 to secured debt (60 percent of the $20 secured debt) and $48 to unsecured debt (60 percent of the $80 unsecured debt).

(H) Recapture Provisions

Basis reduction under I.R.C. section 1017 should not trigger any recapture provisions.[218] Two current recapture provisions are I.R.C. sections 1245 and 1250. These recapture provisions generally apply to any transfer of depreciable property. I.R.C. sections 1245 and 1250 were enacted to close the loophole that resulted from allowing depreciation deductions on assets to offset ordinary income while taxing gain from the sale of these depreciated assets as capital gains. The recapture provisions close the loophole by recharacterizing part or all of the gain on transfers of depreciable assets as ordinary income.

Even though basis reduction itself should not trigger any recapture, the loophole remains closed by I.R.C. section 1017(d), which establishes a recapture rule providing for eventual ordinary income treatment. If basis is reduced in any property that is neither I.R.C. section 1245 property nor I.R.C. section 1250, then that property is treated as I.R.C. section 1245 property, resulting in the recapture of the gain on disposal of the property as ordinary income to the extent of the basis reduction. The amount of reduction is treated as depreciation for the purpose of these sections, and the straight-line depreciation calculation under I.R.C. section 1250 is made as if there had been no reduction in basis resulting from debt forgiveness. This recapture rule may trap the unwary. For example, assume

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[217] Treas. Reg. § 1.1017-1(b)(2).

[218] I.R.C. § 1017(c)(2). Under prior law, if the basis of property on which investment tax credit was claimed was reduced because of debt cancellation, the credit was recaptured as if part of the property were disposed. Rev. Rul. 74-184, 1974-1 C.B. 8, *superseded by* Rev. Rul. 81-206, 1981-2 C.B. 9. The IRS announced in Rev. Rul. 84-134,1984-2 C.B. 6, that it would no longer require a recapture of investment tax credit when taxpayers reduce the basis of property for discharge of indebtedness that occurred before January 1, 1981.

that the basis in the stock of a subsidiary is reduced pursuant to I.R.C. section 108(b). If that subsidiary subsequently liquidates in an otherwise tax-free liquidation under I.R.C. section 332, then the I.R.C. section 1245 recapture may be triggered.[219]

(iii) Tax-Free Asset Transfers

Basis reduction generally occurs on the first day of the tax year following the year the discharge took place.[220] Thus, the basis of property acquired after the discharge, but prior to the end of the tax year following the discharge year, is subject to reduction; similarly, the basis of property sold or otherwise disposed of after the discharge but prior to the beginning of the next tax year is generally not reduced. A taxpayer who faces attribute reduction should carefully consider using the purchase or sale of property as a planning technique.

A tax-free asset transfer or reorganization seems to be a likely candidate for controlling how the basis reduction affects the debtor's tax liability. One potential planning vehicle is a tax-free asset reorganization under I.R.C. section 368(a)(1)(G) (a "G" reorganization), which is discussed in greater detail in Chapter 5. In general, a "G" asset reorganization involves a transfer of assets by a bankrupt corporation (the "target corporation") to another corporation (the "acquiring corporation") in exchange for stock of the acquiring corporation. The bankrupt target corporation distributes the acquiring corporation stock to its creditors and/or shareholders and completely liquidates. Following the "G" reorganization, the target corporation no longer exists.

Although the IRS issued taxpayer-favorable Field Service Advice[221] that allowed a taxpayer to avoid basis reduction following a tax-free reorganization because the target corporation ceased to exist, regulations issued in 2003[222] and the legislative history to the Bankruptcy Tax Act of 1980 will not allow the taxpayer to avoid basis reduction. The House Report includes an example of a "G" reorganization in which the bankrupt target corporation has DOI income that may be excluded from its gross income. The example states that for attribute reduction, the target corporation "may elect to reduce the basis of its depreciable assets transferred to [the acquiring corporation] by all or part of the . . . debt discharge amount; to the extent the election is not made, the debt discharge amount reduces [the target corporation's] net operating loss carryover by the remainder

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[219] See § 2.9(a)(ii) for a discussion of some special I.R.C. 1245 recapture rules in the consolidated return context.

[220] As discussed in § 2.7, there is a debate regarding the timing of attribute reduction in certain situations.

[221] Field Service Advice 200145009 (July 31, 2001). The Field Service Advice involved a target corporation that had DOI income from a title 11 case. Debt was discharged and the target corporation participated in a "G" reorganization in the same tax year. I.R.C. section 108(b) would normally require the target corporation to reduce basis in the year following the discharge. The IRS nevertheless found that there would not be any basis reduction because the target corporation no longer existed, and did not have any property in the year after the discharge.

[222] Treas. Reg. § 1.108-7T; T.D. 9080 (July 17, 2003).

of the debt discharge amount."[223] Thus, the target corporation was required to reduce its tax attributes, including basis, in the context of a "G" reorganization.

Treasury put this issue to bed in final regulations[224] that follow the legislative history guidance. The regulations clarify that, in the case of I.R.C. section 381(a) transactions (e.g., a "G" reorganization or a tax-free I.R.C. section 332 liquidation), any tax attributes of the target corporation to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction must reflect the reductions required by sections 108(b) and 1017. This rule applies to excluded DOI income realized either during or after the tax year in which the taxpayer is the transferor or distributor of assets.

(iv) Comparison of Attribute Reduction and Basis Reduction Elections

The debtor should consider carefully whether to first reduce the tax attributes listed in I.R.C. section 108(b)(2) or to first reduce the basis of depreciable property under I.R.C. section 108(b)(5). Several factors affect this decision.

- If net operating loss carryovers or credit carryovers are expected to expire unused, the debtor should not make the election.
- If the I.R.C. section 108(b)(5) election will result in the reduction of basis in property with a fairly long life for depreciation purposes, the debtor can, in effect, accelerate the depreciation by electing to reduce depreciable property first.
- If the amount of debt that is to be discharged is greater than the tax attributes that will be reduced, the debtor should not make the election. Basis in assets will not be reduced below the amount of post-discharge liabilities; however, this limitation does not apply if the election is made.
- The impact of each alternative on state and local taxes.

The example that follows illustrates the operation of the attribution reduction rules and also illustrates some of the factors that impact a decision to make the basis reduction election. XYZ is negotiating an out of court agreement. The following facts apply:

	Basis	Fair Market Value
Assets (nondepreciable)	$150	$100
Assets (depreciable)	300	140
Liabilities	800	800
Net operating loss carryover (after tax in the year of discharge has been determined)	275	
General business tax credit carryover	25	

[223] H.R. Rep. No. 833, 96th Cong., 2d Sess. at 34 (1980). See § 2.7(d)(i) for a discussion of the basis reduction election of I.R.C. section 108(b)(5). This example was not included in the Senate Report or Conference Report for an unrelated reason. The later versions of the Bankruptcy Tax Act expanded the application of the former stock-for-debt exception, hence, in the context of the House Report example there would be no need to reduce any attributes. *See* S. Rep. No. 1035, 96th Cong., 2d Sess. (1980).

[224] Treas. Reg. § 1.108-7. T.D. 9127, 69 Fed. Reg. 26038 (May 11, 2004).

Under the settlement, one of XYZ's creditors has agreed to accept $100 in full payment of a $500 debt.

Assume that XYZ's depreciable property has a twenty-three year straight-line depreciation period that commenced two years ago. Although it currently is insolvent, there is a strong likelihood that XYZ will return to profitability and that XYZ will be able to utilize its net operating loss carryovers and general business tax credit carryovers in the near term. XYZ does not plan to sell its depreciable property.

However, the fact that XYZ's depreciable property has a high tax basis and a long depreciation period weigh in favor of making an election to reduce the basis of depreciable property first. The fact that XYZ anticipates the utilization of its net operating loss carryovers and general business tax credit carryovers in the near term also contributes to the value of making the election. On the other hand, if XYZ makes the election, there is no limitation to the amount of tax basis that will be reduced. (If the election is not made, the amount of tax basis that will be reduced is limited to $150, which is the excess of tax basis ($450) over liabilities ($300) immediately after the discharge.)

Because XYZ anticipates being able to use its net operating loss carryovers and general business tax credit carryovers in the near term, and because XYZ's depreciable property has a long depreciation period (and there is no plan to sell this property), XYZ opts to make the election to reduce the basis of depreciable property first.

XYZ is insolvent to the extent of $560, which is the excess of liabilities over the fair market value of its assets immediately before the discharge. Although the exclusion of DOI income from gross income is limited to the taxpayer's insolvency immediately before the discharge (I.R.C. sections 108(a) and 108(d)(3)), XYZ's discharge of $400 of debt does not exceed this limitation. Therefore, the entire $400 of DOI income is excluded from gross income under I.R.C. section 108(b). As a result of the election, XYZ will reduce the basis of its depreciable property from $300 to zero[225] on the first day of the tax year following the year of discharge; XYZ will reduce its net operating loss carryovers by $100.

If XYZ did not make the election to reduce the basis of depreciable property first, the $400 of excluded DOI income would first reduce XYZ's net operating loss carryovers from $275 to zero; next, $75 would apply to reduce the general business tax credit carryover from $25 to zero (i.e., the general business tax credit carryover is reduced by 33 1/3 cents for each dollar of DOI income excluded); finally, XYZ would reduce the basis of its property by $100 in the order provided for under Treas. Reg. section 1.1017-1(a). (Here, the limitation on basis reduction of the excess of tax basis ($450) over liabilities following the discharge ($300) is irrelevant, because tax basis only will be reduced by $100.)

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[225] For simplicity, this example ignores any depreciation that may have been taken in the discharge year.

(e) AMTI

For tax years beginning in 1987 through 1989, the alternative minimum taxable income (AMTI) of a corporation was computed by adjusting its taxable income for certain items, including one that was based upon its financial statement income. Although income from debt discharge is not income for regular tax purposes if the debtor corporation is in title 11 or is insolvent, it is generally reported as financial statement income. As a result, debts discharged in tax years beginning in 1987 through 1989 could give rise to increases in AMTI. To avoid such increases, corporations structured debt discharges as quasi-reorganizations for financial statement purposes, reporting gain directly to their capital accounts in order to avoid a discrepancy between taxable income and financial statement income.[226]

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) eliminated the need for quasi-reorganization treatment to the extent stock was exchanged for debt. TAMRA added I.R.C. section 56(f)(2)(I) effective for all tax years beginning after 1986, which provided that the transfer of a corporation's own stock in exchange for the corporation's debt in a bankruptcy case or to the extent the corporation is insolvent does not give rise to financial statement income for alternative minimum tax purposes.[227] I.R.C. section 56(f)(2)(I) was effective for all tax years beginning after 1986, but was repealed as part of the Omnibus Budget Reconciliation Act (OBRA) of 1990.

The OBRA of 1990 replaced the financial statement income adjustment with an adjustment based upon the corporation's adjusted current earnings ("ACE"). Under a provision added to I.R.C. section 56(g)(4)(B)(i) pursuant to the Revenue Reconciliation Act of 1989, however, income excluded under I.R.C. section 108 is not taken into account in determining a corporation's ACE adjustment. This is consistent with the Treasury's general view that all I.R.C. provisions that apply in determining regular taxable income also apply in determining ACE.[228] As a result, for tax years after 1989, income excluded under I.R.C. section 108 should not cause a difference between regular taxable income and AMTI.

§ 2.8 USE OF PROPERTY TO CANCEL DEBT

(a) Transfer of Property in Satisfaction of Indebtedness

When a debtor does not pay secured debts because of financial problems or because of a decline in the value of the mortgaged property, that property is sometimes used to satisfy the debt. If property is transferred in satisfaction of debt, the type of debt (recourse or nonrecourse) determines the federal income tax consequences of the transfer. Although the transfer of property to satisfy a

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[226] For a discussion of quasi-reorganizations, *see* Newton, *supra* note 143 at Chapter 14.

[227] *But see* Technical Advice Memorandum 9402003 (Sept. 9, 1993) providing that former I.R.C. section 56(f)(2)(I) did not apply where a parent corporation issued stock to a subsidiary in exchange for the extinguishment of the parent's debt.

[228] *See* Treas. Reg. § 1.56(g)-1(a)(5).

debt that is greater than the value of the property would appear to result in DOI income, that is not necessarily the outcome.

(i) Transfer of Property in Satisfaction of Nonrecourse Debt

In simple terms, the debtor is personally liable for recourse debt, but the debtor is not personally liable for nonrecourse debt. The creditor's remedy for default of a nonrecourse liability is limited to foreclosure on the property used as security. If the value of that property falls below the amount of the outstanding debt, the debtor is free to abandon the property and be relieved of the obligation. Thus, the creditor bears the risk of the property's loss in value.[229]

(A) Gain from the Property Transfer

Gains derived from dealings in property are includable in the taxpayer's gross income under I.R.C. 61(a)(3). If the owner transfers property subject to a nonrecourse mortgage, gain or loss, calculated under I.R.C. section 1001(a), is the difference between the amount realized on the disposition and the debtor's adjusted basis in the property. The amount realized generally includes the unpaid balance of the nonrecourse mortgage. In *Tufts v. Commissioner*,[230] the Supreme Court held that the amount realized on the sale of an apartment complex includes the balance of the nonrecourse debt, even though the balance exceeded the value of the property. The Court reasoned that if a taxpayer is entitled to include the full amount of the nonrecourse liability in its basis,[231] it is not unreasonable to include that amount in the amount realized when the property is sold.

The rule is the same in the debt satisfaction context. Namely, if the owner transfers property subject to a nonrecourse debt to the creditor in satisfaction of the debt, then the amount realized includes the amount of the debt, even if the debt exceeds the fair market value of the transferred property.[232] This rule can be illustrated by a simple example (see Example 2.1).

EXAMPLE 2.1

Bank lends Debtor $100 and the debt is secured by Property 1. The debt is nonrecourse because Bank can only foreclose on Property 1 to satisfy the obligation. The fair market value of Property 1 is $100 when Debtor borrows the money. Several years later, the value of Property 1 declines to $80. At this time, Debtor's basis in Property 1 is $70. Debtor transfers Property 1 to Bank in satisfaction of the $100 debt.

In these circumstances, Debtor realizes $100 when it transfers Property 1 to Bank, notwithstanding the fact that the value of Property 1 is $80. Debtor will therefore realize a gain of $30 ($100 – $70).

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[229] *Commissioner v. Tufts*, 461 U.S. 300, 311-12 (1983).
[230] *Id*. at 308-310.
[231] *Crane v. Commissioner*, 331 U.S. 1 (1947).
[232] *See* Treas. Reg. § 1.1001-2(c), example 7. This assumes that the reduction of the nonrecourse debt would not qualify as a purchase price adjustment.

Although I.R.C. section 108 applies to a cancellation of nonrecourse debt, a disposition of property subject to a nonrecourse debt does not give rise to DOI income.[233] As shown in Example 2.1, the Debtor does not realize DOI income. DOI income may be preferable to gain in some situations. Returning to the example, assume that Debtor is insolvent by $20. Debtor might argue that the excess of the unpaid nonrecourse debt over the value of the property of $20 ($100 debt – $80 value) is DOI income that is excluded from income under I.R.C. section 108(a)(1)(B) due to Debtor's insolvency. The IRS considered and rejected this argument in a Technical Advice Memorandum,[234] finding that the transaction was governed by I.R.C. sections 61(a)(3) and 1001.[235]

The Tax Court reached a similar conclusion in *Sands v. Commissioner*.[236] The court held that the transfer of property in satisfaction of nonrecourse indebtedness did not result in DOI income and, therefore, could not qualify as a purchase price reduction under I.R.C. section 108(e)(5). In *Sands*, the seller of property forgave nonrecourse debt to the purchaser. As part of the agreement, the seller instructed the buyer (which had leased the property to an unrelated party) to transfer all ownership rights in the property to the lessee and to relieve the lessee of all its obligations under the lease. The court determined that the seller's discharge of debt and the buyer's release of its ownership in the property occurred as part of a single transaction. Thus, in substance, the transfer of property in satisfaction of nonrecourse indebtedness was a taxable sale or exchange. The court held the buyer had gain equal to the excess of the debt forgiven over its adjusted basis in the property under I.R.C. sections 61(a) and 1001(a). This case involves a tricky situation—an apparent reduction of a nonrecourse debt that usually results in DOI income, actually results in capital gain.[237]

(B) Loss on the Property Transfer

A transfer of property in satisfaction of a nonrecourse debt is treated as a taxable sale or exchange that may also result in a loss.[238]

(ii) Transfer of Property in Satisfaction of Recourse Debt

The tax consequences are different if the debtor transfers property in satisfaction of a recourse debt. If the debtor transfers property subject to a recourse debt, gain or loss is calculated on the amount realized. In addition, the recourse

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[233] The discharge of nonrecourse debt is discussed in § 2.8(b).

[234] Technical Advice Memorandum 9302001 (Aug. 31, 1992) (applying *Tufts* and Treas. Reg. 1.1001-2(c) Example 7).

[235] The taxpayers had relied on Rev. Rul. 91-31 (discussed below), which treated the difference between the nonrecourse liability and the value of the property as DOI income. The IRS factually distinguished Rev. Rul. 91-31 because that ruling did not involve a disposition of the property by the debtor, the creditor merely wrote down the face of the debt to equal the value of the underlying security.

[236] 73 T.C.M. (CCH) 2398 (1997).

[237] *See also* 2925 Briarpark, Ltd., 163 F.3d 313 (5th Cir. 1999); Field Service Advice 200135002 (Apr. 10, 2001).

[238] *See, e.g., Freeland v. Commissioner*, 74 T.C. 970 (1980).

transaction may involve a DOI income component.[239] In other words, the transaction is bifurcated for tax purposes.

(A) Gain on the Property Transfer

The transfer of appreciated property in satisfaction of recourse debt may result in both DOI income under I.R.C. sections 108 and 61(a)(12) and capital gain under I.R.C. sections 1001 and 61(a)(3).[240]

EXAMPLE 2.2

Assume that the $100 debt in Example 2.1 is recourse. Because the debt is recourse, the transaction will be bifurcated. Debtor realizes $20 of DOI income, the difference between the amount of the debt ($100) and the fair market value of the property used to satisfy the debt ($80). Debtor also realizes $10 gain from the sale or exchange of Property 1, the difference between the fair market value of the property ($80) and the adjusted basis of the property ($70).

The Tax Court has adopted the bifurcation concept.[241] In *Gehl v. Commissioner*,[242] the Tax Court held that, where property was transferred in full settlement of the recourse debt, the excess of the fair market value of the property over basis is taxable gain under I.R.C. section 61(a)(3), not income from discharge of indebtedness under I.R.C. section 61(a)(12). The court noted that it is "well settled" that a transfer of property by a debtor to a creditor in satisfaction of a debt is a sale or exchange under I.R.C. section 1001 and that the excess of the fair market value over the basis of the property results in taxable gain. The debt satisfaction also included a discharge of indebtedness component. The taxpayer in *Gehl* reported (and the IRS conceded) that the excess of the recourse debt over the fair market value of the property transferred was DOI income. The taxpayer was insolvent before and after having made the transfer in an out-of-court settlement, so the DOI income was excluded from gross income under the insolvency exclusion.[243]

(B) Loss on the Property Transfer

The examples discussed so far involve DOI income and capital gain because the adjusted basis of the property is less than its fair market value. If the

[239] Treas. Reg. § 1.1001-2(a) ("the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."). *See* Field Service Advice 200135002 (Apr. 10, 2001) (discussing the tax consequences of debtor's sale of property securing debt as nonrecourse and, alternatively, as recourse).

[240] Treas. Reg. § 1.1001-2(c) Example 8.

[241] As discussed in § 2.8(c), the IRS also applies this treatment in Rev. Rul. 90-16, 1990-1 C.B. 12 (capital gain and DOI income that is excluded from gross income due to insolvency). *See also* Private Letter Ruling 8928012 (Apr. 7, 1989).

[242] 102 T.C. 784, *aff'd* 50 F.3d 12 (8th Cir. 1995).

[243] I.R.C. § 108(a)(1)(B); § 2.6(b).

adjusted basis of property exceeds the fair market value of the property, the taxpayer may recognize a loss.[244] This is illustrated in Example 2.3.

EXAMPLE 2.3

Bank lends Debtor $100 and the debt is secured by Property 1. The debt is recourse because Debtor personally guaranteed the obligation. The fair market value of Property 1 is $100 when Debtor borrows the money. Several years later, the value of Property 1 declines to $30. At this time, Debtor's basis in Property 1 is $70. Debtor transfers Property 1 to Bank in satisfaction of the $100 debt.

The transaction is again bifurcated. Debtor realizes $70 of DOI income, the excess of the amount of the debt ($100) over the fair market value of the property used to satisfy the debt ($30). Debtor also realizes a $40 loss from the transfer of Property 1, the difference between the adjusted basis in the property ($70) and the fair market value of the property ($30).

(iii) Character of the Gain or Loss

The character of the gain or loss realized when property is transferred in satisfaction of recourse or nonrecourse debt, whether ordinary or capital, is determined by looking at the underlying transaction. In general, when a taxpayer transfers mortgaged property in settlement of a mortgage obligation, any loss sustained is capital because it is "deemed to have resulted from a sale or exchange on the ground that the taxpayer received consideration in return for transferring property, the consideration being . . . release from liability."[245]

The underlying transaction may raise other concerns, including whether the losses are limited by another I.R.C. provision. Under the I.R.C. section 469 passive activity loss rules, losses from passive activities generally cannot be used to offset income from nonpassive activities. Loss from the transfer of property in satisfaction of debt could be a passive loss that is limited by the passive activity loss rules. Similarly, DOI income could be categorized as passive activity income (and offset by a passive activity loss) if the debt was allocated to passive activity expenditures.[246]

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[244] *See* § 2.8(c) for a discussion of Frazier v. Commissioner, 111 T.C. 243 (1998) (transaction bifurcated into a taxable sale of the property resulting in a loss and DOI income). Cf. Private Letter Ruling 9245023 (Aug. 7, 1992) (transfer resulting in a loss but not DOI income where the transferor not relieved of liability).

[245] Freeland v. Commissioner, 74 T.C. 970, 975-76 (1980) (holding that taxpayers' voluntary reconveyance of real property to mortgagee on nonrecourse debt resulted in capital, not ordinary, loss). *See also* Middleton v. Commissioner, 693 F.2d 124 (11th Cir. 1982) (addressing abandonment); Yarbro v. Commissioner 737 F.2d 479 (5th Cir. 1984) (addressing abandonment). *See* § 2.8(c) for same result under foreclosure.

[246] Rev. Rul. 92-92, 1992-2 C.B. 103 (doctrines, such as substance over form and step transaction, may also apply to prevent taxpayers from manipulating the character of DOI income).

(b) Discharge of Nonrecourse Debt

Clearly, if recourse debt is cancelled, then the debtor may have DOI income. Although it is less obvious, the debtor may have DOI income if the debt is nonrecourse. For example, when the value of property securing a nonrecourse debt declines below the amount of the debt, the creditor may reduce the principal amount due and the debtor may realize DOI income. This section discusses transactions that involve a discharge or forgiveness of nonrecourse debt, rather than the transfer of the mortgaged property in satisfaction of the nonrecourse debt, as in *Tufts v. Commissioner* discussed in § 2.8(a)(i)(A) or *Michaels v. Commissioner* discussed in § 2.3(a)(ii).

The similarity in treatment of recourse and nonrecourse debt is shown in Rev. Rul. 82-202.[247] In that ruling, a taxpayer prepaid a home mortgage held by an unrelated lender for less than the principal balance of the mortgage. At the time of the prepayment, the fair market value of the residence was greater than the principal balance of the mortgage. Relying on *Kirby Lumber*,[248] the IRS determined that the taxpayer realized DOI income, regardless of whether the mortgage was recourse or nonrecourse and regardless of whether it was partially or fully prepaid.[249] In Rev. Rul. 82-202, the IRS determined that DOI income arose on facts where the value of the mortgaged property was more than the principal amount of the debt and the IRS believes that the result is the same if the value of the property is less than the principal amount of the debt.

Rev. Rul. 91-31[250] involves a situation where the nonrecourse debt is partially discharged, but the mortgaged property remains in the hands of the debtor. Individual A borrows $1,000 from C at a fixed market rate payable annually. The debt is secured by an office building valued at $1,000 that A acquires from B with the proceeds of the loan. A is not personally liable for the debt. The next year, after the value of the office building declined to $800 and when the outstanding principal due on the debt is $1,000, C agrees to reduce the principal to $800. The modified debt bears adequate stated interest. The IRS determined that A realizes DOI income of $200.

In Rev. Rul. 91-31, the IRS examined *Gershkowitz v. Commissioner*,[251] in which the Tax Court concluded that the settlement of a nonrecourse debt of $250,000 for a $40,000 cash payment (in lieu of the surrender of the collateral consisting of shares of stock with a fair market value of $2,500) resulted in $210,000 of DOI income. The IRS indicated that it will follow the holding in *Gershkowitz* where a taxpayer is discharged from all or a portion of a nonrecourse liability and there

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[247] 1982-2 C.B. 35.

[248] 284 U.S. 1 (1931). *See* § 2.3(a)(iii).

[249] The IRS amplified Rev. Rul. 82-202 in Rev. Rul. 91-31 to also apply if the value of the property is less than the principal amount of the mortgage at the time of the refinancing. *See also* Private Letter Ruling 8314021 (Dec. 29, 1982) (satisfaction of an obligation by paying an amount that is less than the amount of the nonrecourse debt creates income from discharge).

[250] 1991-1 C.B. 19.

[251] 88 T.C. 984 (1987).

is no disposition of the collateral. This is consistent with the determination in Rev. Rul. 91-31 that A realizes $200 of DOI income as a result of the reduction of the principal amount of the nonrecourse note by C, the holder of the debt who was not the seller of the property securing the debt.

To illustrate how the conclusions in *Tufts v. Commissioner* differ from those in Rev. Rul. 91-31, assume that the $1,000 nonrecourse debt owed to C was settled in full by the transfer of the property to C. Further assume that the basis of the property was $700. In this situation, consistent with *Tufts*, debtor A would have a gain on transfer of $300 and none of the gain would be considered income from debt discharge. Moreover, even if A had filed a title 11 petition, the gain would still have been income on the transfer and not subject to the exclusions from income of I.R.C. section 108.

However, if the facts and treatment are consistent with Rev. Rul. 91-31, the debt is reduced and there is no transfer of property, then the filing of a title 11 petition is important. In Rev. Rul. 91-31, the income is subject to the provisions of I.R.C. section 108. Thus, if A was in title 11 proceedings, the income would be excluded and A's tax attributes reduced.

The juxtaposition of the results under the *Tufts* decision, as adopted in Treasury Regulations,[252] and the results under Rev. Rul. 91-31 suggests that a better approach for insolvent taxpayers (or those in bankruptcy) would be to first write down a nonrecourse debt to fair market value, creating DOI income and the attendant attribute reduction. Second, sell the property to an unrelated party and use the proceeds to repay the creditor. Assuming the resulting attribute reduction did not cause a reduction in the basis of the property (but merely a reduction in other attributes), the sale to the unrelated party would result in an I.R.C. section 1001 gain or loss to the extent of the difference between the fair market value in the property (as opposed to the amount of the nonrecourse debt that may exceed the property's fair market value).[253] Taxpayers might be able to achieve the same result by transferring the property directly to the creditor following the write-down. In either scenario, a discharge and subsequent transfer of property made as part of an integrated plan could trigger a recast under the substance over form doctrine.[254]

From a different perspective, the conclusions of *Tufts* and *Gershkowitz* (as followed in Rev. Rul. 91-31) are similar in that the adjustment results in income and not a direct reduction in basis. This is in contrast to a 1934 decision, *Fulton Gold Corp. v. Commissioner*.[255] The continuing value of this decision has been

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[252] *See* Treas. Reg. § 1.1001-2(c), Example 7.

[253] In many instances the taxpayer may be indifferent between I.R.C. section 108(b) attribute reduction and capital gain. For example, net operating losses that would have been reduced under I.R.C. section 108(b) if the debt is discharged may be available to offset *Tufts* gain recognized on the transfer of property subject to nonrecourse indebtedness. Each situation will need to be considered to determine if this potential planning technique is beneficial, particularly in light of the possible limitation on net operating loss utilization for AMT purposes. *See* § 2.7(e).

[254] *See* Sands v. Commissioner, 73 T.C.M. (CCH) 2398 (1997) discussed in § 2.8(a)(i)(A).

[255] 31 B.T.A. 519 (1934)

questioned by the courts and the IRS over the years. In *Fulton Gold* a taxpayer purchased property subject to a nonrecourse mortgage and subsequently satisfied the debt for less than the face amount. Based on *Kirby Lumber*, the Board of Tax Appeals held that there was no DOI income because there was no freeing of assets and required the taxpayer to reduced the basis of property by the difference between the face of the mortgage and the amount paid to satisfy the mortgage. Even though the equity in the property was increased as a result of the discharge, the Board found no DOI income because the taxpayer had incurred no personal liability for the debt. The Board did not consider the taxpayer's equity in the property to be the equivalent of personal liability. In Rev. Rul. 91-31, the IRS concluded that *Tufts* and *Gershkowitz* implicitly reject any interpretation of *Fulton Gold* that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in the property, rather than DOI income for the year of the reduction. In light of conflicting authority on the topic, the continued vitality of *Fulton Gold* is unclear.[256]

(c) Foreclosure

When a debtor defaults on an obligation that is secured by property, the creditor may foreclose on the property in satisfaction of the debt. The property may be sold in a foreclosure sale, with the proceeds from the sale applied to the outstanding debt, in full or partial satisfaction. The tax treatment of the debtor in a foreclosure sale is fundamentally the same as the tax treatment of a debtor that voluntarily transfers property to satisfy debt.

A foreclosure sale is a sale or other disposition of property governed by I.R.C. sections 61(a)(3) and 1001. The difference between the amount realized and the debtor's adjusted basis is a gain or loss, taxed according to the nature of the property.[257] For nonrecourse debt, the amount realized in a foreclosure sale is generally the amount of the debt. For recourse debt, the amount realized in a foreclosure sale is generally the fair market value of the property. The gain or loss on foreclosure is reported in the year in which the foreclosure is final.[258]

In addition to the gain or loss under I.R.C. section 1001, a foreclosure may trigger DOI income if the debt is recourse. If the creditor has a deficiency judgment against the debtor for an amount of recourse debt not satisfied by the sale proceeds and that deficiency judgment is discharged in the foreclosure proceed-

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[256] The Supreme Court, in footnote 11 of *Tufts*, noted that according to one view *Fulton Gold* stands for the concept that, when nonrecourse debt is forgiven, the debtor's basis in the securing property is reduced by the amount of debt canceled, and realization of income is deferred until the sale of the property. The footnote highlights theoretical issues with such a conclusion.

[257] If the property is a capital asset or I.R.C. section 1231 property, the gain will be a capital gain, subject to the depreciation recapture requirements.

[258] For a noncorporation to deduct a loss, the property transferred must have been held as business property or held in connection with a transaction entered into for profit.

ings, then the debtor may have DOI income. The DOI income will be reported in the tax year the debt is discharged.[259]

The similarity in treatment for voluntary and involuntary transfers of property to satisfy recourse debt is illustrated in Rev. Rul. 90-16.[260] The basic fact pattern involves an insolvent debtor's transfer of property that is security for a recourse debt to the creditor pursuant to a settlement agreement. This transfer results in both gain under I.R.C. sections 61(a)(3) and 1001 and DOI income under I.R.C. sections 61(a)(12) and 108. Gain is recognized on the transaction to the extent the fair market value of the property exceeds the debtor's adjusted basis. DOI income is realized to the extent the debt exceeds the fair market value of the property. The basic fact pattern in the Rev. Rul. involves a voluntary settlement agreement, but the ruling specifically points out that the result would be the same if the property were transferred to the creditor in an involuntary foreclosure proceeding. The transfer in foreclosure, like a voluntary sale, is a disposition within the scope of section 1001.[261]

In *Frazier v. Commissioner*,[262] the Tax Court considered a foreclosure sale of property that secured a recourse debt. Consistent with Rev. Rul. 90-16, the Tax Court held that it is appropriate to bifurcate the transaction. With regard to the calculation of gain or loss on the transaction (the difference between fair market value and adjusted basis), the Tax Court held that the fair market value is not necessarily the proceeds from the foreclosure sale.[263] That is, a debtor may show by clear and convincing evidence that the foreclosure proceeds are not the fair market value of the foreclosed property.

The facts of *Frazier* are straightforward. The debtor owned real property that was secured by a recourse obligation. The lender foreclosed while the debtor was insolvent. The lender, the only bidder at the foreclosure sale, bid $571,179 for the property even though the appraised fair market value of the property was $375,000. At the time of the foreclosure sale, the outstanding principal balance on the recourse debt was $585,943 and the debtor's adjusted basis in the property was $495,544. The lender did not attempt to collect the difference between the outstanding debt balance and the bid price for the property. After the foreclosure transaction, the debtor was still insolvent.

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[259] *See Lewis v. Commissioner* 56 T.C.M. (CCH) 1328 (1989), *aff'd*, 928 F.2d 404 (6th Cir. 1991) (ruling that a contract between the debtor and creditor regarding the settlement of a delinquency did not result in income; rather, a subsequent foreclosure sale that relieved the debtor of the balance due resulted in DOI income).

[260] 1990-1 C.B. 12.

[261] Rev. Rul. 90-16 cited *Helvering v. Hammel*, 311 U.S. 504 (1941), *Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941), and *Daneberg v. Commissioner*, T.C. 370 (1979), *acq.* 1980-2 C.B. 1. *See also Freeland v. Commissioner*, 74 T.C. 970 (1980) (addressing a voluntary conveyance but noting same result in context of foreclosure under *Hammel*).

[262] 111 T.C. 243 (1998).

[263] *See also Aizawa v. Commissioner*, 99 T.C. 197 (1992) (proceeds from foreclosure sale are the amount realized for I.R.C. section 1001(a), but the court had no reason to conclude that the sale proceeds were not the fair market value of the property).

The Tax Court found that the foreclosure proceeds were not the fair market value of the property. In its analysis, the Tax Court stated that, absent clear and convincing proof to the contrary, the sales price of property at a foreclosure sale is presumed to be its fair market value. However, the debtor rebutted this presumption to the court's satisfaction by submitting an appraisal for a fair market value of $375,000, which the IRS did not challenge.

The Tax Court next analyzed the federal tax consequences to the debtor, bifurcating the transaction into two steps: a taxable sale of the property and a taxable discharge of indebtedness. On the first step of the transaction, the debtor realized a capital loss of $120,544 (the difference between the fair market value of the property, $375,000, and the adjusted basis of the property, $495,544). On the second step, the debtor realized $210,943 of income from discharge of indebtedness (the difference between the fair market value of the property, $375,000, and the outstanding balance of the debt, $585,943). Because the debtor was still insolvent after the foreclosure transaction, the debtor's income from the discharge of indebtedness was excluded from income pursuant to the insolvency exclusion of I.R.C. section 108(a)(1)(B).

In an earlier decision, *Lewis v. Commissioner*,[264] the Tax Court did not bifurcate a foreclosure sale of property that secured a recourse debt. Rather than viewing part of the transaction as a sale under I.R.C. section 1001, the Tax Court appears to treat the entire transaction as triggering DOI income, measured by the difference between the outstanding debt and the proceeds of the foreclosure sale.

This position is suspect for two reasons. First, Treas. Reg. section 1.1001-2(a) and Rev. Rul. 90-16 suggest that the total amount of the income is the difference between the amount of the debt discharged (amount received) and the basis of the property transferred, and not the amount recovered at the foreclosure sale. Second, regarding the nature of the income, Treas. Reg. section 1.1001-2(a) and Rev. Rul 90-16 suggest that the income consists of two parts: (1) a gain or loss on transfer, calculated as the difference between the fair market value of the property at the time of foreclosure, which may be represented by the purchase price at the foreclosure sale, and the basis of the property; and (2) a gain or loss from debt discharge, calculated as the difference between the amount of the debt and the fair market value of the property. As noted in *Tufts*, if the debt is nonrecourse, the entire amount of the gain (amount of debt less basis in property) is considered a gain on transfer and no part of the gain is subject to the debt discharge rules of I.R.C. section 108.

(d) Abandonment

In the early 1980s, the value of real property dropped dramatically, often leaving owners with mortgages that exceeded the value of the property. If the property were sold, the resulting loss would be a capital loss. In an attempt to characterize the loss as ordinary, the mortgagors would "abandon" the property and

[264] *Lewis v. Commissioner*, 928 F.2d 404 (6th Cir. 1991); reported in full, 1991 U.S. App. LEXIS 4623; aff'g 56 T.C.M. (CCH) 1328 (1989).

claim an ordinary loss. However, as in a voluntary conveyance or foreclosure, it may be difficult to obtain the ordinary loss. In general, as long as the mortgagor retains title to the property, there can be no abandonment. Furthermore, if the mortgagor transfers the property in satisfaction of either a recourse or nonrecourse liability or subject to a liability, it may be even more difficult to show abandonment.

In *Abrams v. Commissioner*,[265] voluntary abandonment was considered a sale for purposes of determining capital loss. The property was held by the debtor as a capital asset. The debtor made a voluntary reconveyance to the seller and called it an abandonment in order to avoid foreclosure. The IRS argued that there was a capital (not ordinary) loss subject to the limitations of I.R.C. section 1211. The Tax Court agreed.

Similarly, in *Middleton v. Commissioner*,[266] the Tax Court held that the abandonment (not in a bankruptcy case) of property subject to a nonrecourse mortgage was a sale and that the loss sustained on the sale of the property was a capital loss.[267] *Middleton* and other cases suggest that it is extremely difficult to abandon property for tax purposes and report the loss as an ordinary loss.

§ 2.9 CONSOLIDATED TAX RETURN TREATMENT

(a) Consolidated Return Issues

I.R.C. section 1501 allows an affiliated group of corporations to file a consolidated federal income tax return. I.R.C. section 1502 provides the Secretary of the Treasury broad authority to issue regulations regarding all aspects of consolidated returns. There are currently over 300 pages of Treasury Regulations and numerous court decisions, revenue rulings, revenue procedures, private letter rulings, technical advice memoranda, and field service advice addressing this area. In addition, several excellent treatises, including *The Consolidated Tax Return*[268] and *Federal Income Taxation of Corporations Filing Consolidated Returns*,[269] countless articles, and outlines are dedicated to this topic. Federal consolidated return rules are one of the most complex areas in tax law; accordingly, refer to these treatises when addressing a consolidated return issue involving debt dis-

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[265] 42 T.C.M. (CCH) 355 (1981). *See also Freeland v. Commissioner*, 74 T.C. 970 (1980); *Arkin v. Commissioner*, 76 T.C. 1048 (1981); *Commissioner v. Green*, 126 F.2d 70 (3d Cir. 1942).

[266] 277 T.C. 310 (1981) *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982). *See also Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir. 1984).

[267] *See also Lockwood v. Commissioner*, 94 T.C. 252 (1990) (applying exchange treatment to taxpayer's abandonment of depreciable property subject to a nonrecourse mortgage, even though the property was destroyed and consequently provided no benefit to the creditor). *But see Hoffman v. Commissioner*, 40 B.T.A. 459 (1939), *aff'd*, 117 F.2d 987 (2d Cir. 1941) (taxpayers were entitled to deduct a loss after the abandonment of property subject to a nonrecourse mortgage) (decided before the Supreme Court's 1947 decision in *Crane*).

[268] Hennessey, Yates, Banks, & Pellervo, The Consolidated Tax Return (6th ed. 2002).

[269] Dubroff, Blanchard, Broadbent, & Duvall, Federal Income Taxation of Corporations Filing Consolidated Returns (2d ed. 2002).

charge or the topics noted below. This section discusses several issues that may arise when the debt of a member of a consolidated group is discharged or, as discussed in greater detail below, is deemed to be discharged.

(i) Election to Treat Stock of a Member as Depreciable Property

A taxpayer that excludes DOI income under I.R.C. section 108(a) must reduce tax attributes under I.R.C. section 108(b). A taxpayer that makes a basis reduction election under I.R.C. section 108(b)(5) first reduces the basis of depreciable property.[270] Consolidated group members may elect to reduce the basis of depreciable property owned by a lower-tier member of the group. I.R.C. section 1017(b)(3)(D) provides that a parent corporation's investment in the stock of its subsidiary shall be treated as depreciable property to the extent that the subsidiary agrees to reduce the basis of its depreciable property. To make this election, the parent and subsidiary must file a consolidated return for the tax year of the discharge. This election is not limited to a single tier; it may be used by a chain of corporations, provided the lowest-tier subsidiary reduces the basis in its depreciable property. Thus, a holding company in financial difficulty may be able to take advantage of an I.R.C. section 108(b)(5) election to reduce basis in stock of its subsidiaries, even though the holding company has no depreciable property.[271]

(ii) Single-Entity versus Separate-Member Approach for Attribute Reduction

(A) Temporary Regulations

When the DOI income of a member of a consolidated group is excluded from gross income, the taxpayer's tax attributes must be reduced under I.R.C. section 108(b). In the consolidated group context, the operative issue is the identity of the taxpayer. Two alternatives exist: the taxpayer's attributes could be the attributes of the group ("single entity") or simply the separate company attributes of the member with excluded DOI income ("separate member"). Although the IRS has issued contrary guidance in this area, its most recent view adopts the single-entity approach.

The temporary regulations, issued in 2003, adopt a hybrid approach to address attribute reduction under I.R.C. section 108(b) when a member of the consolidated group realizes DOI income with respect to debt owed to a creditor

[270] *See* § 2.7(d), Basis Reduction.

[271] *See* Private Letter Ruling 9650019 (Sept. 11, 1996) (when the taxpayer makes an I.R.C. section 1017(b)(3)(D) election, the reduction of basis of depreciable property held by a subsidiary may exceed the taxpayer's basis in the subsidiary stock). Any reduction in excess of stock basis, however, would result in the shareholder member having an excess loss account in the subsidiary stock.

that is not a member of the same consolidated group.[272] Under the temporary regulations the debtor-member's tax attributes are reduced to the extent of the excluded DOI income. If the amount of the debtor-member's excluded DOI income exceeds its tax attributes, the tax attributes of the other members of the group are reduced.

The temporary regulations introduce an ordering rule for purposes of tax attribute reduction under I.R.C. section 108(b) when a member of a consolidated group has excluded DOI income. Under the general rule, first the debtor-member's tax attributes are reduced to the extent of the excluded DOI income.[273] For this purpose, tax attributes attributable to the debtor-member include three components: (1) the debtor-member's share of the consolidated tax attributes;[274] (2) the debtor-member's tax attributes that arose in separate return limitation years (SRLYs);[275] and (3) the basis of property of the debtor-member. In applying the third of these, the debtor-member may reduce, but not below zero, the stock basis of another member of the consolidated group (a "lower-tier member"). If the stock basis of a lower-tier member is reduced, a special "look-through" rule is activated.

Under the look-through rule,[276] the temporary regulations treat the lower-tier member as a debtor-member having DOI income in an amount equal to the reduction in the lower-tier member's stock basis. As a result of this deemed DOI income, the lower-tier member is required to reduce its tax attributes by the amount of the deemed DOI income.

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[272] T.D. 9089, 68 Fed. Reg. 52487 (Sept. 4, 2003), amended by 68 Fed. Reg. 69024 (Dec. 11, 2003). These regulations were published as Temp. Treas. Reg. section 1.1502-28T. T.D. 9089 also amends Treas. Reg. sections 1.1502-19, -21, and -32. These regulations are generally effective for DOI income realized after August 29, 2003, investment adjustments for consolidated years in which the original return is due (without extensions) after August 29, 2003, and excess loss account triggers after August 29, 2003.

[273] Temp. Treas. Reg. § 1.1502-28T(a)(2).

[274] In general, a consolidated tax attribute is an attribute that arose in a year for which the group filed a consolidated return. It is also interesting to note that unlike the normal pro rata use of losses of a group to offset consolidated income, section 108(b) attribute reduction is first applied to reduce attributes of a separate member before they are applied to reduce attributes attributable to other members of a consolidated group.

[275] In general, under Treas. Reg. section 1.1502-1(f), a pre- or post-affiliation year of a member. Under Temp. Treas. Reg. section 1.1502-28T, however, only pre-affiliation losses would be reduced. The Treasury amended the temporary regulations and readdressed the attributes available for reduction when a debtor-member of a consolidated group realizes DOI income subject to I.R.C. 108(a). Under the amendment, the nondebtor-member's attributes that are available for reduction include attributes that arose in a separate return year or a SRLY, to the extent a SRLY is not imposed on those attributes. The amendment applies to DOI income after August 29, 2003 in a tax year with an original due date (without extensions) after December 10, 2003. 69 Fed. Reg. 69024 (Dec. 11, 2003).

[276] Temp. Treas. Reg. section 1.1502-28T(a)(3).

The application of the general rule and the look-through rule is illustrated in Example 2.4:[277]

EXAMPLE 2.4

P forms S on January 1 of Year 1 and S borrows $100 from an unrelated lender. On that same day, S contributes $90 to S1, a newly formed corporation. P, S, and S1, join in the filing of a calendar year consolidated return. During Year 1, the P group has a $100 consolidated net operating loss. Of that amount, $10 is attributable to S and $90 is attributable to S1. None of the loss is absorbed by the P group. As of the close of Year 1, S is discharged from $100 of indebtedness. At the time of the discharge, S is insolvent and has a $90 basis in the S1 stock. Under I.R.C. section 108(a), S's $100 of DOI income is excluded from gross income because of its insolvency.

Under I.R.C. section 108(b) and the temporary regulations, S reduces to $0 its portion of the consolidated net operating loss (i.e., $10). Thereafter, to account for the remaining $90 of excluded DOI income, S reduces the basis of its property (i.e., the S1 stock) from $90 to $0. Because S reduced the basis of the S1 stock, S1 is a lower-tier member subject to the look-through rule. Under the look-through rule, S1 is treated as having DOI income of $90 and S1 reduces to $0 its portion of the consolidated net operating loss (i.e., $90).

Tax attribute reduction may take the form of the reduction of basis in assets. Basis reduction may trigger the recapture rules of I.R.C. section 1245.[278] Recapture may result in certain inequities in the consolidated return context, as explained in the preamble to the temporary regulations:

> For example, assume a member (a higher-tier member) realizes excluded COD income that is applied to reduce the higher-tier member's basis in the stock of another member (a lower-tier member) and, as a result, a corresponding reduction to the basis of property of the lower-tier member is made. The following year, the lower-tier member transfers all of its assets to the higher-tier member in a liquidation to which section 332 applies. Under section 1245, recapture on the lower-tier member's property that is treated as section 1245 property by reason of section 1017(d)(1) is limited to the amount of the gain recognized by the lower-tier member in the liquidation. However, no similar limitation applies to the stock of the lower-tier member that is also treated as section 1245 property. Therefore, the higher-tier member would be required to include as ordinary income the entire recapture amount with respect to the lower-tier member stock. In addition, when the higher-tier member sells the assets of the former lower-tier member the bases of which were reduced, the higher-tier member would be required to include as ordinary income the recapture amount with respect to such assets. In that case, the group may be required to include in consolidated taxable income the amounts representing the same excluded COD income more than once.
>
> The IRS and Treasury Department believe that it is appropriate for the group to include in income as ordinary income amounts reflecting previously excluded COD income only once. Therefore, to prevent a double inclusion of ordinary income amounts representing the same excluded COD income, these regulations provide that a reduction of the basis of subsidiary stock is treated as a deduction allowed for depreciation only to the extent that the

[277] *See, e.g.*, Temp. Treas. Reg. section 1.1502-28T(c), Example 2.
[278] *See* § 2.7(d)(ii)(G).

> amount by which the basis of the subsidiary stock is reduced exceeds the total amount of the attributes attributable to such subsidiary that are reduced pursuant to the subsidiary's consent under section 1017(b)(3)(D) or as a result of the application of the look-through rule. This rule has the effect of limiting the ordinary income recapture amount to the amount of the stock basis reduction that does not result in a corresponding reduction of the tax attributes attributable to the subsidiary.[279]

Under the temporary regulations, if the excluded DOI income exceeds the debtor-member's tax attributes (without regard to the lower-tier member's tax attributes reduced under the look-through rule), the ordering rule of the temporary regulations then requires the reduction of (1) consolidated tax attributes attributable to other members and (2) tax attributes attributable to other members that arose in a SRLY to the extent that the debtor-member is a member of the same SRLY subgroup.[280] For purposes of this rule, a member's basis in its assets is not considered a consolidated tax attribute subject to reduction under the temporary regulations. If the excluded DOI income exceeds the debtor-member's attributes and the attributes referred to in this paragraph, there is no reduction in the amount of the excluded DOI income; nor is any further reduction in attributes or other offset required.

The operation of the consolidated attribute reduction rule is illustrated in Example 2.5.[281]

EXAMPLE 2.5

P forms S on January 1 of Year 1 and S borrows $105 from an unrelated lender. On that same day, S contributes $90 to S1, a newly formed corporation. P, S, and S1, join in the filing of a calendar year consolidated return. During Year 1, S distributes $10 to P, and the P group has a $105 consolidated net operating loss. Of the consolidated net operating loss, $10 is attributable to P, $5 is attributable to S, and $90 is attributable to S1. None of the loss is absorbed by the P group. At the close of Year 1, S is discharged from $105 of indebtedness. At the time of the discharge, S is insolvent and has a $90 basis in the S1 stock. Under I.R.C. section 108(a), S's $105 of DOI income is excluded from gross income because of its insolvency.

Under I.R.C. section 108(b) and the temporary regulations, S reduces to $0 its portion of the consolidated net operating loss (i.e., $5). Thereafter, to account for the remaining $100 of excluded DOI income, S reduces the basis of its property (i.e., the S1 stock) from $90 to $0. Because S reduced the basis of the S1 stock, S1 is a lower-tier member subject to the look-through rule. Under the look-through rule, S1 is treated as having DOI income of $90 and S1 reduces to $0 its portion of the consolidated net operating loss (i.e., $90).

Following the reduction in S's tax attributes (i.e., the reduction of S's $5 portion of the consolidated net operating loss, and the reduction of S's $90 stock basis in S1), only $95 of the excluded DOI income has resulted in tax attribute reduction. Therefore, under the

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[279] T.D. 9117, 69 Fed. Reg. 12069 (Mar. 15, 2004) (preamble).

[280] Temp. Treas. Reg. section 1.1502-28T(a)(4). Treas. Reg. section 1.1502-21(c)(2) for the definition of a SRLY subgroup. *See infra* note 273.

[281] *See*, for example, Temp. Treas. Reg. section 1.1502-28T(c), Example 4.

EXAMPLE 2.5 *(continued)*

temporary regulations the consolidated tax attributes of other group members must be reduced to account for the remaining $10 of excluded DOI income. The only consolidated tax attribute remaining is P's $10 portion of the consolidated net operating loss. Accordingly, this loss is reduced to $0 under the temporary regulations.

(B) Prior to the Temporary Regulations

The temporary regulations governing tax attribute reduction are effective for discharges occurring after August 29, 2003. Prior to the effective date of the temporary regulations, it had been unclear whether attributes would be reduced under the single-entity approach or the separate-member approach discussed in § 2.9(a)(ii)(A), in part because the IRS had issued conflicting guidance. The IRS's prior determinations with respect to this issue create uncertainty for discharges that occurred prior to the effective date of the temporary regulations.[282] Taking the separate-member approach, the IRS ruled privately that each member of a consolidated return group reduces its own tax attributes, without affecting the tax attributes of other members of the group.[283] In a 1991 Private Letter Ruling, the IRS found that "Congress used the term 'taxpayer' in section 108 with the understanding that the attribute reduction rules would not affect other members of a consolidated group absent the making of an explicit election."[284] The IRS specifically noted that I.R.C. section 1017(b)(3)(D)[285] is inconsistent with the single-entity approach. The IRS also discussed the investment adjustment and excess loss account provisions of the consolidated return regulations and concluded that these rules render it unnecessary to reduce attributes of members other than the insolvent members. These were the compelling arguments to support the IRS's conclusion that "the company by company approach requested would be appropriate."

In a later Field Service Advice,[286] however, the IRS departed from its historical analysis and adopted the single-entity approach, ruling that a consolidated return member that excludes DOI income must reduce the group's consolidated net operating loss, even if no part of the consolidated net operating loss is attributable to the member with excluded income.[287] In the Field Service Advice, an

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[282] In addition, prior to the temporary regulations, legislative efforts adopt and expand the single-entity approach. On June 25, 2003, a bill was introduced in the Senate that would apply section 108(b) attribute reduction to all consolidated net operating losses and other consolidated attributes of the group, regardless of whether the source of the attributes is the debtor member. This bill was not limited to the consolidated net operating loss, but requires the netting and reduction of all tax attributes of the consolidated group on a single-entity basis. S. 1331, 108th Cong. (2003).

[283] Private Letter Ruling 9650019 (Sept. 11, 1996); Private Letter Ruling 9121017 (Feb. 21, 1991).

[284] Private Letter Ruling 9121017 (Feb. 21, 1991).

[285] *See* § 2.9(a)(i).

[286] Field Service Advice 9912007 (Dec. 14, 1998).

[287] The IRS also embraced the single-entity approach in Chief Counsel Advice 200149008 (Aug. 10, 2001) and asserted a similar argument in *Peoplefeeders, Inc. v. Commissioner*, T.C. Memo 1999-36. In that case, the Tax Court did not reach the issue; rather it held that another issue was determinative.

insolvent member had DOI income attributable to the cancellation of loans that was excluded from gross income because of the insolvency. The insolvent member claimed that it had no tax attributes to reduce under I.R.C. section 108(b). The IRS disagreed and found that the consolidated net operating loss should be reduced. Finding that the consolidated net operating loss attributable to one member is available to reduce the tax liability of all members,[288] the IRS stated "it is inappropriate" to limit attribute reduction to one particular group member having the DOI income when all members of the group may offset their income with the consolidated net operating loss carryover. In the Field Service Advice, the IRS stated that the earlier Private Letter Ruling is incorrect to the extent it indicates that, in I.R.C. section 108(b), Congress used the term "taxpayer" to limit the tax attribute reduction to a single member.

To further muddy the waters, the United States Supreme Court adopted the single-entity approach to determine a member's losses, albeit in a different context. *United Dominion Industries, Inc. v. United States*[289] involved the determination of how much of a consolidated group's net operating loss is attributable to product liability losses. That amount may be carried back over a ten-year period.[290] The Court held that the amount eligible for the ten-year carryback must be computed on a consolidated basis, as if the group were a single entity, and not under a separate-member approach. Because the amount of a product liability loss is determined by comparing the amount of the taxpayer's product liability expenses to its net operating loss and because the consolidated return regulations recognize only the consolidated net operating loss (and not the separate net operating losses of the members), the Court held that the product liability loss is limited only by the consolidated net operating loss.

In *United Dominion*, the Court determined that there is no such item as a separate net operating loss of a group member, only one consolidated net operating loss.[291] The reach of the *United Dominion* decision with respect to the I.R.C. section 108(b) reduction of net operating losses on a single-entity versus separate-entity basis is unclear for discharges that occurred prior to the effective date of the

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[288] *See* Treas. Reg. § 1.1502-6. Moreover, the IRS argued that Treas. Reg. §§ 1.1502-11 and 1.1502-21 only permit the group to have a net operating loss carryover, so the subsidiary could not have its own net operating loss absent an apportionment event (e.g., disposition of the subsidiary).

[289] 532 U.S. 822 (2001).

[290] Under I.R.C. section 172, a net operating loss generally may be carried back two tax years and used as a deduction to produce an overpayment—and generate a refund—in the earlier year. There is an exception for the portion of a net operating loss relating to product liability deductions or certain other types of expenses. I.R.C. section 172(f) permits the portion of a net operating loss relating to these types of deductions to be carried back ten years. The statute and the consolidated return regulations, however, do not specifically address how the special ten-year carryback rules under I.R.C. section 172(f) apply in the context of a consolidated return.

[291] The provision now contained in Treas. Reg. section 1.1502-21(b)(2)(iv) that defines the amount of the consolidated net operating loss attributable to a departing member does not apply to "unbake the cake." 532 U.S. at 833. That is, although the consolidated return regulations provide a mechanism to apportion net operating losses to a departing member, the Court did not view this as equivalent to a separate member's net operating loss.

temporary regulations, but, at a minimum, the case put more pressure on looking exclusively to an individual member's separate company net operating loss.

(iii) DOI/Stock Basis Adjustments/ELAs

The 2003 temporary regulations addressing attribute reduction modify a complex set of rules for adjusting the basis of the stock of the members of a consolidated group.[292] In general, the basis in a member's stock is increased by the member's taxable and tax-exempt income and decreased by the member's taxable loss, noncapital, nondeductible expenses, and distributions with respect to the member's stock.[293]

The temporary regulations that address attribute reduction amend pre-existing consolidated return regulations to address basis adjustments. The stock basis rules of Treas. Reg. section 1.1502-32 are amended to provide that a subsidiary's excluded DOI income increases a member's stock basis in the subsidiary in an amount corresponding to the reduction in tax attributes (including credits) attributable to *any* member of the group.[294] (The pre-existing regulation did not provide for a positive adjustment if the common parent's tax attribute was reduced; nor did the pre-existing regulation provide for a positive adjustment if the tax attribute reduced was a credit.) This rule may create stock basis in the debtor-member if the debtor-member has excluded DOI income in excess of its separate company attributes (with the result that other members of the group had attribute reduction). The increase in the debtor-member's stock basis is illustrated in Example 2.6.[295]

> **EXAMPLE 2.6**
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> Assume the same facts as the last example. Under Treas. Reg. section 1.1502-32, P adjusts the basis of the S stock to reflect S's excluded DOI income to the extent that the discharge is applied to reduce tax attributes attributable to any member of the group. Because S's excluded DOI income results in attribute reduction of $105 (i.e., $5 of S's loss, $90 of S's basis in S1, and $10 of P's loss), P's basis in S increases by $105. P also has to reduce its basis in the S stock under Treas. Reg. section 1.1502-32(b) to reflect the reduction of its $5 loss under section 108(b), and the $90 reduction of its basis in property under section 1017 (i.e., the S1 stock). Accordingly, the excluded DOI income results in a net positive $10 adjustment to P's basis in the S stock.[296]

Negative investment adjustments that exceed the basis in a member's stock result in a negative basis in the member's stock. This negative stock basis is

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[292] Treas. Reg. § 1.1502-32. The investment adjustment rules do not apply to the common parent. The current consolidated return investment adjustment regulations are generally effective with respect to consolidated return years beginning on or after January 1, 1995. *See* Treas. Reg. § 1.1502-32(h).
[293] Treas. Reg. § 1.1502-32(b).
[294] Temp. Treas. Reg. § 1.1502-32T(b)(3)(ii)(C)(1).
[295] *See, e.g.*, Temp. Treas. Reg. § 1.1502-32T(b)(5)(ii), Example 4.
[296] P's basis in the S stock is also reduced to reflect S's $10 distribution.

referred to as an excess loss account ("ELA").[297] Certain events, such as the transfer of the stock with an ELA outside of the consolidated group or the deconsolidation of a member with an ELA, will trigger the ELA into income of the owner of the member's stock.[298] The gain resulting from triggering ELA is treated as a gain from the disposition of the shares so it usually is a capital gain. One important exception to this rule is that gain resulting from the triggering of an ELA is treated as ordinary income to the extent the member is insolvent.[299]

One event that triggers an ELA is when stock is deemed to be worthless.[300] This generally occurs in two situations:

> Situation 1: Substantially all of the member's stock is treated as disposed of, abandoned, or destroyed for federal income tax purposes (unless the member's asset is the stock of a lower-tier member, the stock is treated as disposed of under this provision); or,
>
> Situation 2: An indebtedness of the member is discharged, the discharge is not included in gross income, and is not treated as tax-exempt income under Treas. Reg. section 1.1502-32(b)(3)(ii)(C) (i.e., no I.R.C. section 108(b) basis reduction); [301]

Temporary regulations issued in 2004 provide that if the inclusion of an ELA is required in connection with the realization of excluded DOI income, then the ELA is included on the return for the tax year that included the date on which the excluded DOI income was realized.[302]

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[297] Treas. Reg. §§ 1.1502-19, 1.1502-32(a)(3)(iii). The current consolidated return ELA regulations are generally effective with respect to consolidated return years beginning on or after January 1, 1995. *See* Treas. Reg. § 1.1502-19(h).

[298] *See* Treas. Reg. section 1.1502-19(c) for all events resulting in a disposition of stock thereby triggering an ELA.

[299] Treas. Reg. § 1.1502-19(b)(4). For this purpose "insolvent" is defined to have the same meaning as I.R.C. section 108(d)(3) plus (1) any amount to which the preferred stock would be entitled if the member were liquidated immediately before the trigger and (2) any former liabilities that were discharged to the extent the discharge is treated as tax-exempt income under Treas. Reg. section 1.1502-32(b)(3)(ii)(C) (i.e., the DOI results in the reduction of tax attributes).

[300] *See also* Field Service Advice 9908005 (Mar. 1, 1999) (IRS concludes that the debtor member of a consolidated group has income in the year the debt becomes worthless. Although the creditor member is entitled to a bad debt deduction, the debtor member has an offsetting amount of corresponding income that is not excludable from gross income under the I.R.C. section 108(a)(3) insolvency exception); Yates, Banks, and Rainey, Deducting Your Loss on Winding Up a Purchased Subsidiary: A Lost Cause?, Vol. 50, No. 1, *The Tax Executive* 19 (Jan.-Feb. 1998).

[301] A third trigger applies if a member takes into account the deduction or loss for the uncollectibility of an indebtedness and the deduction or loss is not matched in the same tax year by the debtor taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income. Due to other changes in the consolidated return regulations, this is unlikely to continue to occur.

[302] T.D. 9117, 69 Fed. Reg. 12069 (Mar. 15, 2004).

The 2003 temporary regulations also amend the pre-existing consolidated return regulations relating to the ELA rules.[303] Previously, these rules provided that the entire ELA would be recognized as income if a debtor-member had excluded DOI income without a corresponding amount of attribute reduction. It appeared that this rule could cause a $100 million ELA to be recognized as a result of $1 of excluded DOI income in excess of attribute reduction. In addition, it also appeared that under prior rules the reduction of a credit could result in the triggering of an ELA in full. As a result of the temporary regulations an ELA is only taken into account to the extent that the excluded DOI income exceeds the amount by which group members' tax attributes (including credits) are reduced.[304]

Finally, the temporary regulations amend the rules for loss absorption under Treas. Reg. section 1.1502-21. Generally, these amendments conform the rules governing the apportionment of a consolidated net operating loss to a member for purposes of carrying that loss to a separate return year with the temporary regulations governing tax attribute reduction.[305]

As noted above, the temporary regulations governing tax attribute reduction are only effective for discharges of indebtedness occurring after August 29, 2003. The amendments to the stock basis rules of Treas. Reg. section 1.1502-32 and the loss apportionment rules of Treas. Reg. section 1.1502-21 are effective for tax years having an unextended return due date after August 29, 2003. The amendment to Treas. Reg. section 1.1502-19 is effective for ELAs taken into account after August 29, 2003.

The amendment to Treas. Reg. section 1.1502-19, however, may be applied retroactively. Taxpayers that recognized an ELA into income as a result of excluded DOI income in excess of the amount of tax attributes reduced should consider applying the amendment to Treas. Reg. sections 1.1502-19 retroactively. In particular, the retroactive application of the amendment would limit the amount of the ELA taken into account to the amount by which the excluded DOI income exceeded the amount of tax attributes reduced.

The amendment to Treas. Reg. section 1.1502-32 may also be applied retroactively. Taxpayers that reduced the tax attributes of the common parent as a result of a subsidiary having excluded DOI income should consider applying the amendment to Treas. Reg. sections 1.1502-32 retroactively. In particular, the retroactive application of the amendment would provide a positive basis adjustment to the stock of the subsidiary if a group member's tax attributes, including those of the common parent, were reduced to offset the subsidiary's excluded DOI income.

[303] Under Treas. Reg. section 1.1502-19, an ELA is negative tax basis. Generally, an ELA is created when the subsidiary has made a debt-financed distribution to its shareholder, or the group has used a debt-financed loss of the subsidiary.

[304] Temp. Treas. Reg. § 1.1502-19T(b)(1)(ii).

[305] Temp. Treas. Reg. § 1.1502-21T(b)(2)(iv).

(iv) Intercompany Obligation Rules

Members of a consolidated group often loan money to each other. Treas. Reg. section 1.1502-13(g) provides rules for the treatment of intercompany obligations.[306] Before summarizing those rules, an overview of the meaning of certain terminology is appropriate.

- A "member" of a consolidated group is a corporation (including the common parent) that is included in the consolidated group.[307]
- An "obligation of a member" is generally a debt of a member for federal income tax purposes, but it also includes certain securities.[308]
- An "intercompany obligation" is an obligation between members of a consolidated group, but only for the period in which both parties are members.[309]

The intercompany obligation regulations are divided into two main parts: the treatment of intercompany obligations and the treatment of obligations that become intercompany obligations.

(A) Intercompany Obligations: General Rules and Application

The intercompany indebtedness regulations include a regime of deemed satisfaction and deemed reissuance. When a member of a consolidated group *realizes* income, gain, deduction, or loss directly or indirectly from the assignment or discharge of any rights relating to an intercompany obligation, the intercompany obligation is treated as satisfied for all federal income tax purposes. If the intercompany obligation remains outstanding, then it is treated as reissued. Similar principles apply if a member realizes income, gain, deduction, or loss directly or indirectly from comparable transactions (e.g., marking the debt to market, taking a bad debt deduction) or if an intercompany obligation ceases to be an intercompany obligation.[310]

The consolidated return regulations provide rules that vary according to which event triggered the application of the intercompany indebtedness rules. The sale of intercompany obligations is addressed in the regulations. If a member sells an intercompany obligation for cash, it is treated as being satisfied immediately before the sale and as being reissued immediately after the sale for the amount of the cash. Similar principles apply to other situations, but in each case the regulations need to be closely analyzed. Under certain circumstances, the sale and reissuance may be deemed to occur based on the fair market value of the indebtedness. In other circumstances, the deemed satisfaction and reissuance may be based on the debt's issue price as determined under the original

[306] Treas. Reg. section 1.1502-13 is generally applicable for transactions occurring in years beginning on or after July 12, 1995. For more effective date rules see Treas. Reg. section 1.1502-13(l).
[307] Treas. Reg. § 1.1502-1(b).
[308] Treas. Reg. § 1.1502-13(g)(2).
[309] Treas. Reg. § 1.1502-13(g)(2)(ii).
[310] Treas. Reg. § 1.1502-13(g)(3)(i)(A).

issue discount (OID) principles of I.R.C. sections 1273 or 1274 (the OID rules).[311] If the deemed satisfaction and deemed reissuance are based on the OID rules, there may not be DOI income or a bad debt deduction because the deemed satisfaction price and reissuance price equal the amount of the obligation.[312]

The existing regulations provide that if an intercompany obligation is transferred for cash or property, in addition to the deemed satisfaction, the obligation is deemed reissued to the purchaser for the cash or property used in the deemed satisfaction. The government stated in the preamble to proposed regulations that the deemed satisfaction and deemed reissuance rules are ambiguous as to the form of the deemed transactions.[313] These ambiguities have been interpreted by some to result in inappropriate income tax consequences. The IRS issued proposed regulations under Treas. Reg. section 1.1502-13(g)[314] to clarify several items, including that the deemed satisfaction proceeds (rather than the obligation) are treated as transferred by the initial creditor in the actual transaction and then advanced by the transferee to the debtor in the deemed reissuance of the obligation. The preamble to the proposed regulations provides that taxpayers may rely on the form and timing of the deemed transactions. Although this assurance is only contained in the preamble to the proposed regulations and may not be binding on the IRS, it would truly be a sad day for the administration of tax law if the IRS or Treasury reneged on this language.

It is very important to note that the general I.R.C. section 108(a) (i.e., for bankruptcy, insolvency) income exclusions do not apply to an existing intercompany obligation.[315] This provision prevents a mismatch in which a creditor member of the group takes a bad debt deduction and the debtor member excludes DOI income. The DOI income and bad debt deduction usually wash, but this needs to be closely analyzed because the regulations are complex and do not always work perfectly.

Although a discussion of every type of transaction implicating the deemed satisfaction and reissuance rules is beyond the scope of this treatise, the operation and complexity of these provisions is best conveyed by a few examples, which are based on examples in the regulations.[316]

Example 2.7

P is the common parent of a consolidated group and owns all the outstanding stock of two members, B and S. B borrowed $100 from S in exchange for a note bearing adequate stated interest. All accrued interest has been paid in full. S subsequently sells the note to M

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[311] Many of the examples in this section use the OID rules to calculate the issue price, but, under certain circumstances, it may be more appropriate to use fair market value.

[312] *See* I.R.C. § 1274; Treas. Reg. § 1.1502-13(g)(3)(ii), (iii).

[313] 63 Fed. Reg. 70354 (Dec. 21, 1998).

[314] *Id.*

[315] In addition, I.R.C. section 354 (nonrecognition for shareholder or security holder in a corporate reorganization) and I.R.C. 1091 (wash sale rules) will not apply to the deemed satisfaction. Treas. Reg. § 1.1502-13(g)(3)(ii)(B)(2).

[316] For additional discussion and examples addressing Treas. Reg. section 1.1502-13(g), see Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns*, § 33.03 (2d ed. 2002).

(another corporation that is also a member of the P consolidated group) for $80. The change in the value of the note was a result of changes in market interest rates. B is not insolvent.

Because S *realizes* income, gain, deduction, or loss directly or indirectly from the assignment or discharge of the intercompany obligation, the deemed satisfaction and reissuance rules apply. The B note is deemed to be satisfied for $80 immediately before the sale, so B has $20 of DOI income. S would appear to have a $20 capital loss under I.R.C. section 1271 due to the deemed retirement of the note. However, the consolidated return regulations require that B's income item and S's loss or deduction item should match in character. Therefore, because B's DOI is ordinary income, S's loss will be an ordinary loss. B is also treated as reissuing a new note directly to M with an $80 issue price and a $100 stated redemption price at maturity with $20 of original issue discount.[317]

EXAMPLE 2.8

The same facts as Example 2.7, except P sells the S stock to NM, a nonmember.

Because the creditor is deconsolidated, the deemed satisfaction and reissuance rules will apply. The note is treated as satisfied by B for its $80 value immediately before S becomes a nonmember and B is treated as reissuing the note to S immediately after S becomes a nonmember. The $20 income to B and $20 loss to S are the same as described in Example 2.7. The new note is not an intercompany obligation and will have an $80 issue price and a $100 stated redemption price at maturity with $20 of original issue discount to be taken into account. The same result would occur if P sells the stock of B to NM.

EXAMPLE 2.9

The same facts as Example 2.7, except B is insolvent at the time of the sale of the note to M.

On a separate entity basis, S's $20 loss from the deemed satisfaction would be capital, and B's DOI income would be excluded from gross income under I.R.C. section 108(a)(1)(B) and subject to appropriate attribute reduction. However, the consolidated return rules provide that I.R.C. section 108(a) does not apply to the deemed satisfaction. Thus, the result is the same as Example 2.7.

EXAMPLE 2.10

The same facts as Example 2.9, except that S does not sell the intercompany obligation to M. Rather, S claims a $20 partial bad debt deduction under I.R.C. section 166(a)(2).

The deemed satisfaction and reissuance rules will apply and the results are the same as in Example 2.9, except that at the end of the day the reissued note (with original issue discount) will remain a note from B to S.

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[317] The form of the transaction under the current regulations would be as follows: B satisfies its note to S with $80 and then B issues a new note in the amount of $100 to M for $80. As described below, proposed regulations may change the order of this fictional transaction. This change would not have a significant tax implication under these facts.

EXAMPLE 2.11

The same facts as Example 2.7, except S transfers the note to a newly formed corporation (Newco) in exchange for all the outstanding stock of Newco.

Although no gain or loss is *recognized* by S on the transfer of the note to Newco due to the application of I.R.C. section 351,[318] S will nevertheless *realize* a loss on its exchange of the note ($100 face amount less $80 value). The realization of an amount, even if nothing is recognized, will result in the application of the intercompany obligation rules. This triggers the deemed satisfaction and reissuance rules, regardless of the fact that the note is transferred within the consolidated group in a nonrecognition transaction.

Under the existing regulations, B is treated as satisfying the obligation for fair market value immediately before S transfers the obligation to Newco because S transfers the note to another member of the consolidated group in exchange for property. B is treated as satisfying the note for an amount equal to the issue price of the deemed reissued note as determined under the OID rules. Because the obligation bears adequate stated interest (both at the time of issuance and at the time of the transfer of the note) and because neither the note nor the Newco stock is publicly traded, the note is deemed satisfied for an amount equal to the amount of the obligation. Therefore, B would not have DOI income.

One cautionary note: the outcome under the existing regulations lends itself to a recast. Although the IRS and Treasury have issued proposed regulations that would avoid the recast, those regulations have not been finalized. Under the existing final regulations, the transaction could be recast as follows. First, B could be treated as issuing a new note directly to Newco in exchange for Newco stock. This would probably qualify as a tax-free I.R.C. section 351 exchange.[319] If B is viewed as having zero basis in its own obligation, then B would take a zero basis in the hypothetical Newco stock received in the exchange and Newco would have a zero basis in the deemed newly issued B obligation.[320] The transaction is not complete because all the Newco stock is actually owned by S. In the second part of the recast transaction, B could be treated as transferring the hypothetical Newco stock that it was deemed to receive (with a zero basis) to S in exchange for the amount S received in the deemed satisfaction. If B had a zero basis in the stock, B would recognize a gain on this deemed sale to the extent of the difference between the basis and the property received. Although this gain would be deferred under the consolidated return regulations, it could be triggered under certain circumstances. For example, if S or B becomes a nonmember or if the Newco stock is transferred outside the consolidated group, then B would recognize the gain. Additional issues could arise on any future payments on the obligation that was deemed to be reissued, because an issue exists as to whether that obligation also has a zero basis.

This is the nightmare scenario that the proposed regulations are designed to avoid. Under the proposed regulations, B's note would be treated as satisfied for $100 (the issue

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[318] For a discussion of section 351, see footnote 100.

[319] B should satisfy the 80-percent stock ownership requirement necessary to qualify for I.R.C. section 351 treatment because under Treas. Reg. section 1.1502-34, B can take into account Newco stock owned by all members of its consolidated group.

[320] *See* I.R.C. §§ 358 and 362. Certain authority provides that the note is not transferred with a zero basis. *Perracchi v. Commissioner*, 143 F.3d 487; *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989). However, the Tax Court and the IRS have held that the note does have a zero basis. *Lessinger v. Commissioner*, 55 T.C. 622 (1971); Rev. Rul. 68-629.

price of the note under the OID rules) immediately before S's transfer of the note to Newco. No gain or loss is recognized by S or B on the deemed satisfaction of the note. S would then be treated as transferring the deemed proceeds from the satisfaction of the note ($100) to Newco in exchange for the Newco stock. S's basis in the Newco stock will be $100. Newco's basis in the reissued note will be $100 because B is treated as reissuing the note to Newco for $100.

EXAMPLE 2.12

P is the common parent of a consolidated group and owns all the outstanding stock of member S. S borrowed $100 from P in exchange for a note bearing an adequate stated interest rate. The note is not publicly traded. P's adjusted basis in the note is $100. P forgives the debt by contributing the note to S. At this time, the note continues to bear an adequate stated interest rate, although the fair market value of the note has dropped to $90.

The contribution of the note arguably results in an amount realized, and thus, the deemed satisfaction rules apply.[321] It is unclear, however, whether the debt is deemed satisfied for the debt's fair market value ($90) or for the adjusted issue price of the note ($100). This result will either be DOI income to the debtor and loss to the creditor of $10, respectively (if the deemed satisfaction is the $90 fair market value) or no DOI or loss (if the deemed satisfaction is the $100 adjusted issue price under the OID rules). This uncertainty is a function of whether property (namely stock of S) should be deemed issued to P as consideration for the discharge in line with the meaningless gesture doctrine discussed above in § 2.4(c)(ii)(A). A contribution of the debt for no consideration would support using the debt's fair market value to determine DOI income and a deemed stock-for-debt exchange would tend to support using the adjusted issue price (as determined under the OID rules) to determine the amount of DOI income. In addition, because the note is discharged in the transaction, it should not be deemed reissued. Moreover, P should be treated as making a capital contribution to S in the amount for which the note is deemed satisfied (potentially $90 or $100 as discussed above). In either situation, the general rules governing section 108(e)(6) capital contributions of indebtedness appear to be supplanted by the consolidated return regulations.[322]

EXAMPLE 2.13

P is the common parent of a consolidated group and owns all the outstanding stock of member S. P borrowed $100 from S in exchange for a note bearing an adequate stated interest rate. The note is not publicly traded. S's adjusted basis in the note is $100. S forgives the debt by distributing the note to P. At this time, the note continues to bear an adequate stated interest rate, although the fair market value of the note has dropped to $90.

The distribution of the note results in an amount realized, and thus, the deemed satisfaction rules apply. Apparently, no property is transferred in either an actual or deemed satisfaction of the note. It also appears that the calculation of the deemed satisfaction amount, which was considered in Example 2.12, is an issue in this fact pattern. Once again, the resolution of this question is unclear because the regulations do not

(continues)

[321] The deemed issuance rules do not apply because the note does not remain outstanding.
[322] *See* discussion at § 2.4(b).

EXAMPLE 2.13 *(continued)*

address whether the debt is deemed satisfied for $90 (the note's fair market value) or for $100 (the note's adjusted issue price determined under the OID rules). The arguments for using the OID rules may be weaker in this fact pattern than in the Example 2.12 capital contribution context because there is no actual or deemed transfer of property in exchange for the note. In any event, the note would not be deemed to be reissued because it is discharged in the transaction. S is deemed to distribute the proceeds from the deemed satisfaction to P as a section 301 distribution.[323]

(B) Obligations That Become Intercompany Obligations

A separate set of rules govern a non-intercompany obligation that becomes an intercompany obligation.[324] Said another way, these rules will apply if a debtor and the holder of the obligation are not members of the same consolidated group and something occurs that causes the debtor and the holder to become members of the same consolidated group. The debtor and the holder could become members of the same consolidated group in many ways, such as: (1) the debtor is a member of a consolidated group and another member of the group purchases the obligation from a nonmember; (2) the debtor is a member of a consolidated group and a member of the group purchases the stock of the nonmember/holder of the obligation, causing the holder to become a member of the consolidated group; (3) the holder of the obligation is a member of a consolidated group and a member of the group purchases the stock of the debtor, causing the debtor to become a member of the consolidated group; and (4) the debtor and the holder of the obligation are members of an affiliated group that does not file a consolidated return, and the group makes an election to file a consolidated return.

The following federal income tax consequences will occur if a debt becomes an intercompany debt (and an exception to the rule is not applicable):

- DOI income may be excluded from gross income under I.R.C. section 108(a) (i.e., for bankruptcy, insolvency), when a non-intercompany obligation becomes an intercompany obligation.
- I.R.C. section 108(e)(4) (related-party acquisition of debt) will not apply.
- The debt will be treated for all federal income tax purposes, immediately after it becomes an intercompany debt, as satisfied and as new debt issued to the holder in an amount determined under the principles of Treas. Reg. section 1.108-2(f).
- The attributes of all items resulting from the deemed satisfaction are taken into account on a separate entity basis, rather than treating the debtor and holder of the obligation as divisions of the same corporation (the general consolidated return rule). Thus, it may be possible for the debtor to recog-

[323] Note that this distribution is made in the consolidated return context, thus Treas. Reg. section 1.301-1(m) may not apply. *See* footnote 30 and accompanying text for a discussion of similar transactions that do not involve consolidated groups.

[324] Treas. Reg. § 1.1502-13(g)(4). The regulations, however, provide that they will not apply if the obligation becomes an intercompany by reason of an event that is an exception to the application of I.R.C. section 108(e)(4) or in a transaction that will not have a significant effect on any person's tax liability.

nize ordinary income from the discharge of indebtedness and the creditor to recognize capital loss on the deemed satisfaction of the obligation.

- The I.R.C. sections 354 (nonrecognition for shareholder or security holder in a corporate reorganization) and 1091 (wash-sale rules) will not apply to the deemed satisfaction.

Certain special rules with respect to consolidated return stock basis adjustments will apply.[325]

EXAMPLE 2.14

P is the common parent of a consolidated group and owns all the outstanding stock of two members, B and S. B borrowed $100 from NM (a nonmember of the consolidated group) in exchange for B's note. All accrued interest has been paid in full. Three years later, when the fair market value of the note is $70, P buys all the NM stock, causing NM to become a member of the P consolidated group. B is solvent at this time.

Under the regulations, B is treated as satisfying its debt for $70 (determined under the principles of Treas. Reg. section 1.108-2(f)) immediately after NM becomes a member. Both NM's $30 capital loss (generated on the deemed satisfaction of the $100 note for $70 and B's $30 of DOI income (ordinary income) are taken into account (i.e., not deferred) in the year of the deemed satisfaction. The mismatch in character occurs because the attributes are determined on a separate entity basis. Other provisions, such as I.R.C. section 382 and Treas. Reg. section 1.1502-15, could impact the utilization of the capital loss. B is also deemed to issue a new intercompany obligation to S with a $70 issue price, a $100 stated redemption price at maturity, and $30 of original issue discount.

Example 2.14 is the same example as provided in Treas. Reg. section 1.1502-13(g)(5), example 4. The example, however, leaves some questions unanswered. For instance, how was the $70 deemed satisfaction for fair market value determined? As noted above, when a nonintercompany obligation becomes an intercompany obligation, the obligation is deemed to be satisfied in an amount determined under section 1.108-2(f). More specifically, section 1.108-2(f)(2) applies to determine the deemed satisfaction amount. That part of the regulation states:

> *Holder did not acquire the indebtedness by purchase on or less than six months before the acquisition date*. Except as otherwise provided in this paragraph (f), the amount of discharge of indebtedness income realized . . . is measured by reference to the fair market value of the indebtedness on the acquisition date if the holder (or the transferor to the holder in a transferred basis transaction) did not acquire the indebtedness by purchase on or less than six months before the acquisition date.

How the deemed satisfaction fair market value is determined depends on how the obligation became an intercompany obligation. The straightforward situation occurs when a non-intercompany obligation is acquired for cash by a member of a consolidated group that includes the debtor. Here, the obligation should be treated as satisfied and reissued for the amount of the cash.

In another scenario, Treas. Reg. section 1.108-2(f)(1) seems to apply. That regulation provides as follows:

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[325] Treas. Reg. § 1.1502-13(g)(4)(ii).

> *Holder acquired the indebtedness by purchase on or less than six months before the acquisition date.* Except as otherwise provided in this paragraph (f), the amount of discharge of indebtedness income realized . . . is measured by reference to the adjusted basis of the related holder (or of the holder that becomes related to the debtor) in the indebtedness on the acquisition date if the holder acquired the indebtedness by purchase on or less than six months before the acquisition date. For purposes of this paragraph (f), indebtedness is acquired "by purchase" if the indebtedness in the hands of the holder is not substituted basis property within the meaning of section 7701(a)(42). However, indebtedness is also considered acquired by purchase within six months before the acquisition date if the holder acquired the indebtedness as transferred basis property (within the meaning of section 7701(a)(43)) from a person who acquired the indebtedness by purchase on or less than six months before the acquisition date.

Treas. Reg. section 1.108-2(f)(2) may apply if the obligation became an intercompany obligation because the debtor and holder of the obligation become members of the same consolidated group (i.e., generally the stock of the debtor or the holder is acquired by the consolidated group that includes the other party). In that case, the obligation will generally be deemed satisfied and reissued by reference to the holder's basis in the obligation, provided the obligation was acquired by purchase within six months of becoming an intercompany obligation.[326] This provision did not apply to Example 2.14 because the indebtedness was not acquired by purchase by NM within six months of NM becoming a member and B becoming members of the same consolidated group.

In other circumstances, the debt of a member of a consolidated group that is owned by a nonmember may be purchased by another member of the consolidated group. In this instance, it appears that 1.108-2(f)(2) would result in a deemed satisfaction and reissuance for an amount equal to the fair market value of the indebtedness. It has been suggested that the issue price of the deemed reissued debt as determined under the OID rules should serve as a surrogate for fair market value in such situations. As discussed above, if the debt and the property that is used to acquire the debt are not publicly traded and the debt bears a rate of interest equal to or in excess of the applicable federal rate, then the application of the OID rules to determine the amount of the deemed satisfaction will result in no DOI income. The application of the OID rules in under these circumstances, however, is uncertain.

§ 2.10 DISCHARGE OF INDEBTEDNESS REPORTING REQUIREMENTS

(a) Information Reporting Requirements for Creditors

The Revenue Reconciliation Act of 1993 added I.R.C. section 6050P to the Code, requiring certain entities to report discharges of indebtedness of $600 or more. The treasury regulations set forth the time, form, and manner of reporting under I.R.C. section 6050P.[327]

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[326] Treas. Reg. § 1.108-2(f)(1).

[327] The IRS issued temporary and proposed regulations in 1993. Temporary regulations section 1.6050P-1T was effective January 1, 1994 for discharges of indebtedness after December 31, 1993. Final regulations section 1.6050P-1 generally became effective for discharges of indebtedness occurring after December 2, 1996 with an election to apply them to a discharge occurring after January 1, 1996. Prop. Treas. Reg. section 1.6050P-2, which addresses money lenders, was published on June 13, 2002, and will become effective after final regulations are issued.

(i) Applicable Entity

In general, an "applicable entity" that discharges $600 or more of the debt of any person must file an information return on a Form 1099-C.[328]

An applicable entity includes an executive, judicial, or legislative agency, or an "applicable financial entity," such as a bank, savings and loan association, or credit union.[329] The reporting requirement was later extended to "any organization a significant trade or business of which is the lending of money."[330]

(ii) Amount Reported

The applicable entity must report the entire amount of discharged indebtedness income, even though the debtor is not taxed (e.g., one of the I.R.C. section 108(a)(1) exclusions apply).[331] Reporting the discharge of interest is not required.[332] Multiple discharges are not aggregated for reporting purposes, unless the separate discharges are pursuant to a plan to avoid reporting.[333]

(iii) Identifiable Event

Information reporting is only required if an identifiable event has occurred.[334] The regulations list eight identifiable events:

1. Discharge under title 11, if the creditor knows that the debtor incurred the debt for business or investment purposes.[335]
2. Discharge in receivership, foreclosure, or similar proceedings in either federal or state court.[336]

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[328] I.R.C. § 6050P; Treas. Reg. § 301.6050P-1(a)(1).

[329] I.R.C. § 6050P(c). More specifically, applicable financial entities include; (1) any financial institution described in I.R.C. section 581 or 591(a) (generally, banks, mutual savings banks, cooperative banks and domestic building and loan associations, and other savings institutions) and any credit union, (2) the FDIC, RTC, NCUA and any other federal executive agency, and any other successor or subunit of such, (3) any other corporation which is a direct or indirect subsidiary of an entity referred to in (1) above, but only if, by virtue of being affiliated with the entity, the corporation is subject to the supervision and examination by a federal or state agency that regulates such other entities, and (4) organizations significantly engaged in the trade or business of lending money.

[330] I.R.C. § 6050P(c)(2)(D), added by P.L. 106-170 § 553(a) (1999); see also Prop. Treas. Reg. § 301.6050P-2 (proposed regulations addressing what is a significant money lending trade or business, including safe harbors).

[331] Treas. Reg. § 301.6050P-1(a)(3).

[332] Treas. Reg. § 301.6050P-1(d)(2).

[333] Treas. Reg. § 301.6050P-1(a)(2).

[334] Treas. Reg. § 301.6050P-1(b).

[335] Treas. Reg. § 301.6050P-1(b)(2)(i)(A), -1(d)(1). Indebtedness is considered incurred for business purposes if it is incurred in connection with the conduct of any trade or business (except performing services as an employee). Indebtedness is incurred for investment purposes if it is incurred to purchase property held for investment as defined in I.R.C. section 163(d)(5).

[336] Treas. Reg. § 301.6050P-1(b)(2)(i)(B).

3. Discharge on the expiration of the statute of limitations for collecting the debt, if upheld in a final judicial proceedings; or discharge on the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding.[337]
4. Discharge pursuant to an election of foreclosure by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness.[338]
5. Discharge pursuant to probate or a similar proceeding.[339]
6. Discharge for less than full consideration pursuant to an agreement between an applicable entity and a debtor.[340]
7. Discharge pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and to discharge the debt.[341]
8. The expiration of the non-payment testing period during which no payment was made.[342]

(iv) Exceptions

There are some exceptions to the reporting requirements. The discharge of non-principal amounts (e.g., penalties) in a "lending transaction"[343] does not need to be reported. Reporting is not required for the discharge of debt of foreign debtors to foreign branches of U.S. financial institutions.[344] An applicable entity is not required to report discharge that is deemed under I.R.C. section 108(e)(4), the related-party acquisition rule.[345] Reporting the release of a co-obligor on the debt is not required, if the other debtors remain liable for the entire unpaid amount.[346] Similarly, no information reporting is required for guarantors.[347]

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[337] Treas. Reg. § 301.6050P-1(b)(2)(i)(C), -1(b)(2)(ii).
[338] Treas. Reg. § 301.6050P-1(b)(2)(i)(D).
[339] Treas. Reg. § 301.6050P-1(b)(2)(i)(E).
[340] Treas. Reg. § 301.6050P-1(b)(2)(i)(F). *See* Private Letter Ruling 200212004 (Dec. 20, 2001) (finding Treas. Reg. § 301.6050P-1(b)(2)(i)(F) not applicable).
[341] Treas. Reg. § 301.6050P-1(b)(2)(i)(G), -1(b)(2)(iii). *See* Private Letter Ruling 200212004 (Dec. 20, 2001) (finding Treas. Reg. § 301.6050P-1(b)(2)(i)(G) not applicable).
[342] Treas. Reg. § 301.6050P-1(b)(2)(i)(H), -1(b)(2)(iv). The testing period is 36 months, increased by the number of months the creditor was stayed from collection. This creates a rebuttable presumption that an "identifiable event" has occurred. This presumption may be rebutted if the creditor has engaged in significant collection activity (during the last 12 months of the 36-month period). Significant collection activity does not include merely nominal or ministerial collection activity, such as automated mailing.
[343] Any transaction in which a lender loans money to, or makes advances on behalf of, a borrower (including revolving credits and lines of credit). Treas. Reg. § 301.6050P-1(d)(3).
[344] Treas. Reg. § 301.6050P-1(d)(4).
[345] Treas. Reg. § 301.6050P-1(d)(5). See § 2.4(a) for a discussion of I.R.C. section 108(e)(4).
[346] Treas. Reg. § 301.6050P-1(d)(6).
[347] Treas. Reg. § 301.6050P-1(d)(7).

(v) Multiple Debtors

The reporting requirements for a discharged debt with multiple debtors depend on when the debtors incurred the debt and the amount of the debt. In general, if the debt discharged is less $10,000 or if the debt was incurred before January 1, 1995 (regardless of the amount), then reporting is only required for the primary, or first-named, debtor. But if the discharged debt is $10,000 or more and the debt was incurred after December 31, 1994, then the reporting requirements apply to each debtor. Nevertheless, only one information return is required for multiple debtors that are husband and wife.[348] Unless clear and convincing proof shows that multiple debtors are not jointly and severally liable for the debt, then the entire amount of the discharge is reported for each debtor.[349]

(vi) Multiple Creditors

If discharged indebtedness is owned (or treated as owed for federal income tax purposes) by more than one creditor, then each creditor that is an applicable entity must comply with the reporting requirements. A lead bank, or other designee, may file the information return on behalf of the other creditors.[350]

(b) Filing Requirements for Debtors

Debtors are required to file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, upon either the exclusion of income or the reduction of tax attributes under I.R.C. section 108.

The instructions to Form 982 provide that the form should be filed with a timely filed (including extensions) tax return for the tax year that the discharge of indebtedness is excluded from gross income under section 108(a). Form 982 with instructions is reprinted in section § 2.7(b) as Exhibit 2.1.

Recall that an identifiable event triggers reporting under I.R.C. section 6050P. The debtor could report DOI income, even though the debt remains legally enforceable. The creditor's subsequent collection actions could cause the debtor to repay the obligation, either voluntarily or involuntarily. In this situation, the debtor should file an amended tax return for the year DOI income was reported.[351]

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[348] Treas. Reg. § 301.6050P-1(e)(1)(i).

[349] Treas. Reg. § 301.6050P-1(e)(1)(ii).

[350] Treas. Reg. § 301.6050P-1(e)(2).

[351] This assumes that the tax year remains open. *See* Significant Service Center Advice 200235030 (June 3, 2002). The IRS also concluded that under the applicable facts the taxpayer would not be entitled to a deduction under an alternate "Claim of Right" theory under section 1341 because (1) the discharge did not occur under a claim of right and (2) the payment of a personal loan is not deductible. *See* the following two articles addressing this Advice: Raby and Raby, Tax Traps IN Form 1099-C Discharge of Indebtedness, 2002 TNT 225-46 (November 19, 2002); Raby and Raby, Taxpayer Repayments and the Tax Benefit Rule, 2002 TNT 228-26 (November 25, 2002).

CHAPTER THREE

Partnerships and S Corporations: Tax Impact of Workouts and Bankruptcies

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§ 3.1 INTRODUCTION

As the number of real estate failures and workouts has increased, the tax consequences of debt modifications and discharge of partnership debt, exchange of partnership interest for debt, and termination of partnership interest have received more attention from tax practitioners and the IRS. Tax law changes during the 1980s resulted in an increase in the number of corporations electing the S status. These corporations have incurred financial problems, as have many C corporations.

Although the tax consequences for workout and bankruptcy purposes of a partnership are significantly different from those of an S corporation, both entities are discussed in this chapter because the profits and losses from each type of entity are generally passed through to the partners or the shareholders.

This chapter describes the major tax issues that arise when a troubled partnership or S corporation files a bankruptcy petition or attempts to solve its financial problems in an out-of-court workout.

§ 3.2 PARTNERSHIPS

(a) General Provisions

Considerable confusion existed in prior law as to the proper way to handle discharge of partnership debt. The confusion centered around a controversial decision in the Fifth Circuit. In *Stackhouse v. United States*,[1] discharge of a partnership debt was not treated as income to the partnership but was deemed to be a distribution to the individual partners under I.R.C. section 752 (b). As a result, partners would recognize income only to the extent that their shares of the debt discharge exceeded their bases in the partnership interest, in accordance with I.R.C. section 731(a). Under prior practice, the gain from debt discharge was first reviewed at the partnership level. If nonrecognition was permitted, then, under Treas. Reg. section 1.61-12(b), the nonrecognition was considered at the partner level. For example, the IRS claimed that partners received a constructive cash distribution under I.R.C. section 752(b), which reduced the basis of the partners' interests under I.R.C. sections 705 (a) and 733.[2] Taxability was determined under I.R.C. section 731(a) after applying the insolvency exception in Treas. Reg. section 1.61-12(b). The degree of interplay between I.R.C. sections 752(b) and 61(a)12 was, however, very unclear.[3]

The Tax Court ruled on two cases involving this issue in 1987. In *Gershkowitz v. Commissioner*,[4] the first case outside the Fifth and Eleventh Circuits (note that the Fifth Circuit's decision in *Stackhouse* predates the creation of the Eleventh Circuit), the court held that the taxpayer (partner) had to recognize ordinary income at the time the debts were discharged under I.R.C. section 702 (a)(8).

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[1] 441 F.2d 465 (5th Cir. 1971). *See* Rev. Rul. 71-301, 1971-2 C.B. 257.

[2] Rev. Rul. 71-301, 1971-2 C.B. 257 (The Ruling is now obsolete due to changes to § 108 by the Bankruptcy Tax Act of 1980).

[3] Thompson & Tenney, Partnership Bankruptcy—The New Entity and Individual Tax Consequences, 35 *Tax Law*. 89, 103-104 (1981).

[4] 88 T.C. 984 (1987).

This income provided each partner with an increase in basis under I.R.C. section 705(a) (1)(A). At the same time, each partner received a distribution from the partnership equal to his or her share of the debt canceled under I.R.C. section 752(b). Thus, there would be no net change in the partner's basis—an increase under I.R.C. section 705 and a distribution and decrease in basis under I.R.C. sections 752 and 733. In a decision arising in the Eleventh Circuit (*Moore v. Commissioner*),[5] the Tax Court determined that it was bound by the Fifth Circuit's decision in *Stackhouse* and would therefore reach a result contrary to the decision in *Gershkowitz.* In *Moore,* the court held that income from discharge of a partnership debt was capital gain and not ordinary income, based on the reasoning in the *Stackhouse* case as discussed above. Both *Gershkowitz* and *Moore* were based on the code prior to its amendment by the Bankruptcy Tax Act of 1980.

I.R.C. section 108(d)(6), which was added by the Bankruptcy Tax Act of 1980, overturned the *Stackhouse* decision by providing that income from debt cancellation would not be excludable at the partnership level, but would instead be allocated to the individual partners under I.R.C. section 702. Thus, the debt discharge is applied at the partner level rather than at the partnership level. In addition, the earlier disallowance of nonrecognition if the discharge results in the solvency of the partner no longer applies in a title 11 case.

If a partner receives money from the partnership under an obligation to repay the money, this is a loan and not a distribution of property. If the partnership subsequently cancels the partner's debt, Treas. Reg. section 1.731-1(c)(2) requires the partner to realize income from debt discharge. In a liquidation of a partnership, the taxpayer must be able to present evidence that part of the amount received related to debt canceled, in order to claim that the income on liquidation was from debt discharge.[6]

The IRS, in Rev. Proc. 92-35[7], announced that if, under local law and the partnership agreement, the bankruptcy or removal of a general partner of a limited partnership causes the dissolution of the partnership, unless the remaining general partners or at least a majority in interest of all remaining partners agree to continue the partnership, then the IRS will not take the position that the limited partnership has the corporate characteristic of continuity of life. Rev. Proc. 92-35 applies to all limited partnerships whose partnership agreements contain, specifically or by operation of local law, the above provision.

(b) Responsibility for Filing Tax Returns

I.R.C. section 1399 provides that no new entity is created when a case is filed by a partnership under the provisions of the Bankruptcy Code. Likewise, no new entity is created for a corporate bankruptcy. The bankruptcy trustee would be required to file a partnership information return (Form 1065) under I.R.C. section 6031 for the period(s) during which the trustee was operating the business.

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[5] 54 T.C.M. (CCH) 749 (1987).

[6] *See Zager v. Commissioner*, 53 T.C.M. (CCH) 230 (1982), *aff'd without opinion*, 842 F.2d 332 (9th Cir. 1988).

[7] 1992-1 C.B. 790.

The committee reports indicate that it is the responsibility of the trustee to file the partnership return, although this is not specifically required by the statute.[8] In a Private Letter Ruling,[9] the IRS held that a trustee of a partnership is responsible for filing Form 1065 only for the year during which the trustee was appointed and subsequent years. No obligation exists to file Form 1065 for earlier partnership years. The trustee must, however, cooperate with the IRS by providing any and all relevant tax information he or she may have concerning prior years. In another Private Letter Ruling,[10] the Service indicated that in preparing a partnership return for which prior years were not filed, the trustee should base the return for the first year in which he has the responsibility for filing on all the information that is available. If additional information becomes available, an amendment can be made to the return.

In *In re Samoset Associates,*[11] the Bankruptcy Court held that there is no specific requirement for the filing of federal income tax returns by the trustee in bankruptcy of a partnership in ordinary bankruptcy proceedings. The court discovered no authority for the proposition put forth by the government that I.R.C. section 6012 imposes a duty on the trustee in bankruptcy of a bankrupt partnership to file income tax returns. I.R.C. section 6012 imposes responsibility for the filing of federal income tax returns on individuals, fiduciaries and receivers, and corporations.

Samoset involved a liquidation under the Bankruptcy Act after an effort to reorganize under Chapter XII had failed. The court justified the decision not to require a return because the partnership was in the process of liquidating the assets of the partnership.[12]

In several situations, a question has arisen as to who will cover the cost of preparing the return if no free assets are available. The bankruptcy court addressed one aspect of this issue in *In re Cotswold Village.*[13]

The trustee for Cotswold Village Investors, Inc. (and a number of other related companies that filed under chapter 11) was unable to hire accountants to prepare the debtor's tax returns because the assets of the debtor were frozen. The trustee filed a motion seeking an order indicating that he had no responsibility for filing partnership tax returns for the debtors. The government claimed that a trustee has a statutory duty to file these returns.

The court noted that a chapter 11 trustee is charged by the statute with many responsibilities, but could find no instance requiring the trustee to finance the expense out of his or her own personal resources. The bankruptcy court, however, ruled that the trustee may apply to the court for an order to assess the cost of the preparation of the returns against the partners of the debtors. The court also noted that the filing would be to the benefit of the partners of the debtor.

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[8] S. REP. NO. 1035, 96th Cong., 2d Sess. 26 (1980).

[9] Private Letter Ruling 8509038 (Nov. 30, 1984).

[10] Private Letter Ruling 8535015 (May 31, 1985).

[11] 14 B.R. 408 (Bankr. D. Maine 1981).

[12] As a result of *Holywell Corp. v. Smith*, 112 S. Ct. 1021 (1992), it may be difficult for a chapter 7 trustee to use this reason to avoid filing a partnership return. The Samoset court noted that a partnership is not a separate entity for tax purposes as was suggested in Rev. Rul. 68-48, 1968-1 C.B. 301, and, as a result, it is not required to file a tax return.

[13] No. 87-00846-SWC; LEXIS 88 TNT 235-23 (Bkrtcy. N.D. Ga. 1988).

The National Office of the IRS issued a "policy statement" change indicating that it would issue prompt determination letters only on returns for which there is a tax liability. The Service no longer issues determination letters for partnerships. However, it is still advisable for the debtor to request such a letter and properly document the request. For example, in *In re First Securities Group of California, Inc.*,[14] the bankruptcy court considered the request valid over the objection of the IRS. See § 10.3(a) for a discussion of this case.

(i) Partnership Entity

The filing of a partnership petition creates a separate estate[15] for bankruptcy purposes but, as noted above, no new estate (entity) is created for tax purposes. The partnership may file a chapter 7, 11, or 12 petition. Thus, the partnership return is filed in its normal manner as though no bankruptcy petition was filed.

On the filing of a chapter 7 petition, the estate is turned over to the trustee. The functions of the trustee are to protect the assets of the partnership, to liquidate the partnership in an orderly manner, and to distribute the proceeds according to the priority order provided by the Bankruptcy Code. Although the partnership is liquidated, the debts are not discharged; only an individual can obtain a discharge in a chapter 7 proceeding.[16]

If the estate is unable to pay all creditors' claims, then each general partner is liable to the trustee for the full amount of the deficiency.[17] If any of the general partners wants a discharge, such partner must file a separate bankruptcy petition. Furthermore, section 723(b) of the Bankruptcy Code provides that the trustee, to the extent practicable, must seek recovery from general partners that are not debtors in a title 11 case.

(ii) Partnership Disposition

A transfer of the partnership interest of an individual in bankruptcy to the estate does not result in a disposition for any Internal Revenue Code purpose.[18] Section 364(g)(1)(A) of the Bankruptcy Code provides that no gains or losses will be recognized for state and local tax purposes.[19]

A transfer of 50 percent or more of the interest in a partnership by an individual to the bankruptcy estate will not terminate the partnership under I.R.C. section 708.[20] A partnership that files a petition continues in existence, even

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[14] SIPA No. LA 92-01156 KM (Bankr. C.D. Cal. Oct. 7, 1997).
[15] 11 U.S.C. § 541.
[16] *Id.* § 727(a)(1).
[17] *Id.* § 723(a).
[18] I.R.C. § 1398(f). Section 346(g)(1)(A) of the Bankruptcy Code provides that no gain or loss will be recognized.
[19] Thompson & Tenney suggested that this provision may not be adequate to prevent recapture of investment tax credit under a state or local provision that is equivalent to I.R.C. section 47., *supra* note 3, at 92.
[20] *Id.* at 93; *see also* Rev. Rul. 68-48, 1968-1 C.B. 301, and I.R.C. § 1398(f).

though an estate is created for bankruptcy purposes.[21] Thus, there has not been a termination of the partnership.

(iii) Administrative Expenses

The Bankruptcy Code provides that administrative expenses are deductible for state and local tax purposes.[22] Also, administrative expenses are deductible by an individual.[23] This provision (I.R.C. section 1398(h)(1)) refers to section 503 of the Bankruptcy Code, which allows for an administrative expense deduction for all estates—individuals, partnerships, and corporations. It would appear that the partnership would incur the same type of administrative expenses as an estate of an individual and should be entitled to the deduction from income earned at the partnership level. An alternative interpretation of these expenses would be that they are deductible at the partner's level, but not by the partnership. However, unlike the provision for debt discharge,[24] no special provision was made for this treatment. Thus, it might be presumed that a partnership can deduct the administrative expenses.

(c) Types of Debt Restructurings

During the last half of the 1980s and in the early 1990s, large numbers of real estate investors and developers were unable to make the payments required by their loan agreements. As a result, properties have been sold at losses or the debt has been restructured. Many owners have allowed the properties to be sold, transferred to the lenders through foreclosure proceedings, or deeded to the mortgage holders in lieu of foreclosure.

Debt of partnerships can be restructured in many different ways; however, the methods can be classified into four basic types:

1. Modification of terms.
2. Purchase price reduction.
3. Reduction of principal.
4. Exchange of some or all of the debt for a partnership interest.

(i) Modification of Terms

Many lenders have agreed to modify the terms of their debt instruments rather than foreclose on a property or seek other types of action against debtors. In these cases, the debtors need to consider the tax impact. Generally, a modification of the debt does not have any tax impact, but an exchange (or a "material" modification) of one debt instrument for another may have adverse tax consequences. Modification typically involves altering the maturity date and/or the

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[21] I.R.C. § 1399.
[22] 11 U.S.C. § 346(e).
[23] I.R.C. § 1398(h)(1).
[24] I.R.C. § 108(d)(6).

interest rate. In some partnerships, the modification may involve the conversion of recourse debt to nonrecourse.

The extent to which a modification can be made without being construed as an exchange or a "material" modification became controversial because of (1) the repeal of I.R.C. section 1275(a)(4) by the Revenue Reconciliation Act of 1990, and (2) the decision of the Supreme Court in *Cottage Savings Association v. Commissioner*.[25] The Court held that an exchange of mortgage pools was taxable because each pool represented a legally distinct entitlement. The Court rejected the IRS's argument that there was a material modification due to an economic analysis and instead held that a material modification existed because the holder of the properties enjoyed legal entitlements that were materially different in kind and extent. *Cottage Savings* involved the exchange of mortgage portfolios by two savings and loan associations.

As a result of *Cottage Savings,* the IRS issued regulations[26] intended to help determine when a modification of a debt instrument is sufficient to warrant the recognition of a gain or loss.[27] Where the modification is material and an exchange is found to occur, income from debt discharge will be determined by comparing the excess of the adjusted price of the old debt over the issue price of the new debt. For a discussion of what type of modification is considered an exchange and how the gain is determined see § 2.4(d)(iii)(B).

An issue in many real estate workouts is whether the conversion of debt from nonrecourse to recourse or vice versa is a material modification. As noted above, a change in the collateral, according to Rev. Rul. 73-160, was not considered a material modification. If the conversion is from recourse to nonrecourse, it might be argued that income from debt discharge should be realized to the extent that the debt exceeds the fair market value of the collateral. To claim this difference as income, it would appear that the IRS would have to show that the parties to the adjustment did not expect repayment. There was some concern that the IRS might use an antiabuse argument to claim that if the new or modified debt instrument is nonrecourse, then issue price of the new instrument should not exceed the fair market value of the debt instrument that was eliminated. Income from debt discharge would result if the value of the original debt instrument was less than the balance. The final regulations adopt the rule of the proposed regulations that a change in the recourse nature of an instrument is a significant modification, but limit this specific rule to changes from substantially all recourse to substantially all nonrecourse, or vice versa. If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under the general significance rule. Importantly, the final regulations provide that a modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in

[25] 11 S. Ct. 1503 (1991).
[26] Treas. Reg. section 1.1001.-3.
[27] See § 2.4(d)(iii)(B) of the text for a discussion of the regulations.

payment expectations. See §2.4(d)(iii)(B) for a detailed discussion of the rules related to debt modification.

Although a recourse–nonrecourse modification of a debt instrument may not result in income from debt discharge for a debtor partnership and eventually for the partner, the modification may result in a recognized gain for the individual partner. For example, if the modification alters the allocation of the debt between partners under I.R.C. section 752, gain may be recognized.

(ii) Purchase Price Reduction

I.R.C. section 108(e)(5) provides that no income from debt discharge is created when a purchase money debt containing a mortgage on specific property of a solvent nonbankrupt debtor is reduced. I.R.C. section 108(e)(5) does not apply to insolvent debtors or to title 11 debtors. However, the IRS, in Rev. Proc. 92-92,[28] provides that, for a partnership that is either bankrupt or insolvent for purposes of I.R.C. section 108, the IRS will not challenge the partnership's treatment of a reduction (in whole or in part) of an indebtedness owned by the partnership as a purchase price adjustment, provided the transaction would qualify as a purchase price adjustment for purposes of I.R.C. section 108(e)(5) were it not for the bankruptcy or insolvency of the taxpayer.

The IRS noted that the favorable tax treatment will not apply to a partnership if any partner adopts an income tax reporting position regarding the debt discharge that is not consistent with the partnership's income tax treatment of that discharge.

In *Hirsch v. Commissioner*,[29] the Seventh Circuit held that a discharge of debt qualifying as an adjustment of purchase price allows adjustments of specific asset basis in lieu of general attribute reduction. I.R.C. section 108(e)(5) applies only to adjustments that are made between the original buyer and the original seller. However, several commentators regard I.R.C. section 108(e)(5) as a safe harbor rule and not one that disallows the reduction of purchase price when the debt is held by a third party.[30] The IRS held, in Rev. Rul. 91-31,[31] that the reduction of the principal amount of an undersecured nonrecourse debt by the holder of the debt, who was not the seller of the property securing the debt, results in the realization of income from debt discharge. See § 2.8(b) for a discussion of Rev. Rul. 91-31.

(iii) Reduction of Principal

In cases where the value of the collateral is much less than the amount of a nonrecourse note, the lender may agree to reduce the debt. As noted above, a reduction in principal is considered a material modification of the debt. Under these

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[28] 1992-2 C.B. 505.

[29] 115 F.2d 656 (7th Cir. 1940).

[30] *See* Malek, Tax Issues Relevant to Partnership Workouts, *Proc. 9th Ann. Reorg. & Bankr. Conf.* 5 (1993); Shenfield and Maynes, Selected Issues in Partnership Debt Restructuring, 68 *Taxes* 861, 880 (Dec. 1990), especially cases cited at note 98.

[31] 1991-1 C.B. 19.

conditions, the debtor will have income from debt discharge regardless of the nature of the debt—recourse or nonrecourse. See § 2.4(d) for a complete discussion of debt-for-debt exchanges.

(A) Cancellation of Real Property Business Indebtedness

The Omnibus Budget Reconciliation Act of 1993 allows individuals, partnerships, S corporations, and fiduciaries to exclude from gross income gain due to the discharge of qualified real property business indebtedness. Qualified real property business indebtedness is indebtedness that (1) is incurred or assumed in connection with real property used in a trade or business and (2) is secured by the real property. Qualified real property business indebtedness does not include qualified farm indebtedness. However, special rules under I.R.C. section 108(g) allow solvent farmers to make the election to reduce tax attributes. Debt incurred or assumed by the taxpayer after December 31, 1992, will qualify only if it was incurred or assumed in connection with the acquisition, construction, reconstruction, or substantial improvement of real property, or to finance the amount of any qualified real property business indebtedness.

The amount that is excluded cannot exceed the excess of the outstanding principal of the debt just prior to discharge over the fair market value of the business property that is the security for the debt. For the purposes of determining the fair market value of the property, the fair market value of the property is reduced by the outstanding principal amount of any other debt secured by the property.

Reduction in the basis of depreciable property may not exceed the adjusted basis of the depreciable real estate held by the taxpayer immediately before the discharge, determined after any reductions that might be required under I.R.C. sections 108(b) and (g). The basis is determined as of the first day of the next taxable year—or earlier, if the property is disposed of after the discharge occurs and before the end of the taxable year. Thus, basis in property other than the property that secures the debt that was discharged may be reduced under this provision. To some extent, this new legislation codifies the ruling in *Fulton Gold Corp. v. Commissioner*.[32] *Fulton Gold* held that the reduction of a nonrecourse debt was not income from debt discharge but should rather be reflected in basis reduction.

Consider the following example involving an S corporation that owns a building with a fair market value of $600,000 and a basis of $500,000. The building is pledged as security for a first mortgage for $530,000 and a second mortgage for $150,000. The corporation settles the second mortgage for a payment of $50,000 and has $100,000 of cancellation of debt income. If the debtor so elects, it may exclude from income $80,000—the amount by which the second mortgage exceeds the value of the property less the outstanding principal of any other debt securing the property [$150,000 – ($600,000 – $530,000)]. The basis of the property will be reduced by the amount of income from debt discharge that is excluded from current income, or $420,000 ($500,000 – $80,000).

[32] 31 B.T.A. 519 (1934).

The corporation will be required to report as income $20,000 of the $100,000 of gain realized from debt discharge.

Fred T. Witt Jr. and Michael G. Frankel[33] have indicated that the IRS needs to clarify several issues relating to the new qualified real property business indebtedness exception under I.R.C. section 108(a)(1)(D), added by the Omnibus Budget Reconciliation Act of 1993. Several of these authors' suggestions are items that have remained unaddressed since the passing of the Bankruptcy Tax Act of 1980. Among the issues raised by Witt and Frankel, and their suggestions for resolving some of them, were:

- In what manner is the I.R.C. section 108(a)(1)(D) election to be made? Is the election made by filing Form 982 with the taxpayer's return for the year in which the discharge occurs (recognizing that the basis and depreciation deductions need to be adjusted on the return)? Can the election be made only on a timely filed return (or will elections on amended returns be permitted)?
- Is it possible to elect to exclude part of the discharge income that otherwise qualifies under I.R.C. section 108(a)(l)(D)? For example, a taxpayer might prefer to report part of the gain from the discharge of debt as income under I.R.C. section 61(a)(12).
- For debt incurred or assumed before January 1, 1993, accrued but unpaid interest that is added to principal under the terms of the applicable debt instrument should increase the principal amount of the indebtedness that qualifies.[34] Such interest also would increase the amount of the debt that is used for limitation purposes of I.R.C. section 108(c)(2)(A)(i).
- To apply I.R.C. section 108(c)(2)(B), guidance is needed regarding the convention that is to be used to determine the taxpayer's aggregate adjusted basis in his or her depreciable real property immediately before the discharge.
- The Tax Court definition of a "trade or business" applicable to rental real estate should be used in interpreting the statutory requirement of I.R.C. section 108(c)(3)(A). The debt must be incurred or assumed "in connection with real property used in a trade or business."[35]
- The requirement in I.R.C. section 108(c)(3)(A) that the debt must be "secured by such real property" needs to be clarified. Will this requirement be met if the security interest is defective for some reason under local law? Witt and Frankel believe that such a defect should not affect qualification under I.R.C. section 108(c) because local rules of perfection are intended to determine priorities among competing creditors.
- The broad term "real property" is used in the definitional provision of I.R.C. section 108(c)(3)(A), which means that both land and building

[33] 61 *Tax Notes* 121 (Oct. 4, 1993).

[34] *See Allen v. Commissioner*, 856 F.2d 1169, 1174 (8th Cir. 1988).

[35] *See Hazard v. Commissioner*, 7 T.C. 372 (1946), *acq'd,* 1946-2 C.B. 3 (rental of former residence held to be a trade or business).

qualify. Witt and Frankel noted that Rev. Rul. 75-515[36] indicates that, for I.R.C. section 1031 purposes, real estate has been recognized to include both improvements and land.

- Assuming the taxpayer qualifies and an amount of discharge income is excluded, I.R.C. section 108(c)(1)(B) provides that the reduction in the basis of depreciable real property is to be made in the manner described in I.R.C. section 1017. No revised regulations have been issued and, in the Bankruptcy Tax Act of 1980, Congress specified that the order of basis reduced under I.R.C. section 108 was to follow the prior law (I.R.C. section 1016 regulations). Witt and Frankel believe that the I.R.C. section 1017 regulations are better suited to basis reductions under I.R.C. section 108(c).
- It should be immediately clarified that, if a partner elects to reduce his or her basis in a partnership interest where the partnership owns depreciable real property, the adjustments made by the partnership should be made on the same basis and in the same manner that basis adjustments are made under I.R.C. sections 743 and 754.
- The Treasury Department ("Treasury") should promptly amend the provisions of Treas. Reg. section 1.704-2(f) to provide a specific exception to the minimum gain chargeback requirement, which otherwise will apply when a partnership's basis in its depreciable property is reduced and such property is encumbered by nonrecourse debt. Otherwise, as Witt and Frankel have pointed out, the benefits of I.R.C. section 108(c) under these circumstances will be nullified.
- Treasury should provide an exception to the recapture rule of I.R.C. section 465(e) where the amount at risk is reduced below zero as a result of a basis reduction under I.R.C. section 108(c).
- An upper-tier partnership's share of the qualified real property business indebtedness of a lower-tier partnership should be treated as qualified real property business indebtedness of the upper-tier partnership.
- Guidance is needed regarding the manner in which a partnership should maintain its books and records to reflect a decrease in a partner's share of the partnership's depreciable asset basis.

(iv) Exchange of Debt for Partnership Interest

In cases where a partnership is not able to make its debt payments, the lender, rather than foreclose on the property, may agree to accept an interest in the partnership in exchange for cancellation of all or part of the debt of the partnership. For a discussion of the tax impact of the exchange of debt for an equity position in the partnership, see § 3.2(j).

[36] 1972-2 C.B. 466 (1972) [Rev. Rul. 2003-99 held Rev. Rul. 75-515 obsolete and no longer considered determinative, 2003-34 I.R.B. 388.

(d) Partnership Impact

The handling of a cancellation of a partnership debt may be summarized in the following manner:

1. Under I.R.C. section 705, each partner's basis in the partnership is increased by his or her distributive share of the income of the partnership resulting from the debt discharge.
2. The corresponding decrease in the partnership's liabilities will result in a distribution under I.R.C. section 752, decreasing each partner's basis in his or her partnership interest under I.R.C. section 733. The basis reduction under I.R.C. section 733 will offset the increase under I.R.C. section 705. These adjustments are separate from any other basis or attribute reduction that is required under the Bankruptcy Tax Act.

(e) Partner Level Impact

The tax treatment of an individual partner as a result of debt discharge will depend on the financial status of each individual partner. A solvent partner who has not filed a bankruptcy petition would consider the debt cancellation to be income unless the discharge occurred prior to January 1, 1987, and the partner elected to reduce the basis under the qualified business indebtedness provision. An insolvent partner or partner in bankruptcy would be subject to rules that apply to the debt discharge of income for taxpayers under those conditions. The taxpayer would either reduce certain tax attributes or first elect to reduce the basis of depreciable property.

(i) Reporting by Partners

The income from debt discharge is treated as a separately stated line item to each partner under I.R.C. section 702 (a).

As noted in § 3.2(d), the partner's basis is reduced by a constructive distribution of cash caused by the reduction in partnership liabilities under I.R.C. section 731. Under I.R.C. section 731(a) (1), the partner may be required to recognize income to the extent that the constructive distribution exceeds the partner's basis. For example, a gain would be recognized in a situation where the partner's allocated share of the income from debt discharge is less than the constructive cash distribution and the partner does not have enough basis to absorb the excess of basis reduction under I.R.C. sections 752 and 731 over the increase in basis under I.R.C. section 704(b).

However, the partner may have a larger basis in the partnership if the partner's share of the income from debt discharge exceeds the constructive distribution of cash under I.R.C. section 731.

In *Babin v. Commissioner*,[37] the Sixth Circuit held, in a pre-1980 Bankruptcy Tax Act law case, that an insolvent partner is not entitled to an increase in basis because the partner did not report income as the partner was insolvent. In *Babin*,

[37] 23 F.3d 1032 (6th Cir. 1994).

the bankrupt partnership reached an agreement with a bank, discharging over $2.4 million of secured debt. Under the partnership agreement, the taxpayer was allocated 51 percent of the income from debt discharge (approximately $1.2 million) as a general partner. The taxpayer increased his basis by the amount of debt discharged under I.R.C. section 705. Section 705 provides that each partner's basis in the partnership is increased by his distributive share of the partnership income resulting from the debt discharge. Under I.R.C. section 752 there is a deemed distribution and resulting decrease in each partner's basis to the extent that each partner is liable for the debt. While these are independent adjustments, they would generally cancel each other out prior to *Babin.* However, if the partner's allocable share of partnership debt is greater than his share of partnership income (as was the case of the partner in *Babin*), the deemed distribution will be greater than the basis increase. This could result in the recognition of gain by the partner if the partner's basis was otherwise insufficient to support the deemed distribution. In *Babin,* the taxpayer was liable for 75 percent of the partnership debt under the partnership agreement, resulting in a deemed distribution of over $3.9 million from the debt settlement. When the taxpayer considered the increase in basis of $1.2 million, the deemed distribution of approximately $3.9 million resulted in a taxable gain. However, when the basis increase was disallowed, the taxpayer recognized almost $1.3 million of taxable gain on the deemed distribution.

The Sixth Circuit concluded that taxpayer's $1.2 million share of the partnership's income from debt discharge did not pass through to the taxpayer because it was not taxable due to the insolvency exception. The court held that the basis adjustment provided under I.R.C. section 705 (a) (1)(A) applies only to income from debt discharge that is taxed to the individual partner or passes through to that partner. Thus, if the partner is in bankruptcy or falls under the insolvency exception, the Sixth Circuit ruled that the income is not taxable and thus no basis increased would be allowed under I.R.C. section 705.

As noted earlier, this decision was based on the Internal Revenue Code in effect prior to the amendments by the Bankruptcy Tax Act of 1980. Thus, it would appear that this ruling should not apply to cases based on the Code after amended by the Bankruptcy Tax Act of 1980. In spite of a clear legislative intent to reverse resultings in cases like *Babin,* Sheryl Stratton, reporting on a meeting of the ABA Tax Section on Real Estate, notes that some agents are evidently still citing *Babin* as good law.[38] Although the Service has made no formal announcement regarding the applicability of *Babin* to post-Code filings, it has indicated informally that it assumes that *Babin* applies only to pre-Code cases.

The Tax Court has held that a Texas woman's community interest in a loss passed through from her husband's partnership had to be reduced by the excluded discharge of indebtedness (DOI) income that was also passed through.[39]

[38] 71 *Tax Notes* 1013 (May 20, 1996).
[39] *Brickman v. Commissioner*, T.C. Memo. 1998-340, 76 T.C.M. (CCH) 506.

The taxpayers argued that the DOI income was not community property because it was generated by the husband's release from his guaranty of the promissory note. The Tax Court found that the DOI income was generated by the bank's discharge of Sovereign's indebtedness. Because the taxpayers stipulated that the partnership interest was community property under Texas law, the Tax Court held that any income and deductions attributable to that partnership interest were also community property.

(ii) Allocation to Individual Partners

Under Rev. Rul. 92-97,[40] if a partner is allocated a share of the partnership's cancellation of debt (COD) income that differs from the partner's share of the canceled debt under I.R.C. section 752 (b), the allocation of income from debt discharge must have substantial economic effect under I.R.C. section 704(b). The IRS concluded that the allocation difference has substantial economic effect under I.R.C. section 704(b) if:

- The deficit restoration obligations covering any negative capital account balances resulting from the DOI income allocations can be invoked to satisfy other partners' positive capital account balances.
- The requirements of the economic effect test are otherwise met.

Substantiality is independently established.

These rules will disallow any allocation of income from debt discharge that is different from the partner's share of the debt, even though such an allocation is provided in the partnership agreement and the allocation complies with an alternative test for economic effect.

Rev. Rul. 92-97 contains two examples that illustrate the allocation procedure.

(iii) Discharge of Partnership Debt

In a technical advice, the Service ruled that when a bankruptcy court discharges a partner from his share of a partnership recourse debt, the partner's tax consequences are determined under I.R.C. sections 731 and 752, and not under I.R.C. sections 61(a)(12) and 108(a).[41] The Service further ruled that the partner's tax consequences from his acceptance of cash in cancellation of a liability owed him by the partnership are, depending on the facts, determined under I.R.C. sections 731, 752, and 166.

In June 1986, the partner sold rental property to the partnership in exchange for a note payable of $49,621. He reported the sale under the I.R.C. section 453 installment method. The partnership made monthly payments on the note through June 1991. It made no payments after that, leaving both principal and accrued interest due. As of December 31, 1992, the partner maintained that he was owed $49,166 on the note. In addition, the partnership had also incurred $279,000 in third-party secured debt.

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[40] 1992-2 C.B. 124.

[41] Private Letter Ruling 9619002 (May 20, 1996).

When the partner filed a chapter 7 voluntary bankruptcy petition, he listed his share of the partnership's secured debt as a liability. He did not list his portion of the note payable as a debt on his bankruptcy petition, but he did list it as an asset. At that time, the partner had a negative capital account of $91,000 and a basis in his partnership interest of $18,000.

Under the subsequent bankruptcy order, the partner was released from all dischargeable debts, including his $93,000 share of the secured debt. Before the end of 1992, the court closed the partner's bankruptcy estate, and the partnership interest reverted to him.

The Service pointed out that under Treas. Reg. § 1.752-2, a partner's share of partnership recourse debt equals the portion of economic risk of loss borne by the partner. Excluding the note payable, the partnership owed $279,000 of recourse debt when the partner filed his bankruptcy petition. The partner had a one-third interest in the partnership, so his share of the debt was $93,000. When that debt was discharged, a deemed distribution was created under I.R.C. section 752(b). Based on Rev. Rul. 94-4,[42] the Service ruled that a deemed distribution of money under section 752(b) resulting from a decrease in a partner's share of partnership liabilities is treated as an advance or drawing of money under Treas. Reg. § 1.731-1(a)(1)(ii). This distribution is taken into account at the end of the partnership tax year.

Thus, the deemed distribution took place on December 31, 1992, the last day of the partnership's 1992 tax year. At that time, the partner's bankruptcy estate was closed, and the partnership interest, with a tax basis of $18,000, had already reverted to him. Consequently, the partner recognized a gain of $75,000 ($93,000 - $18,000) under I.R.C. section 1001. Depending on the application of I.R.C. section 751(a), the Service said, the gain may be capital or ordinary. The Service noted that this result is consistent with the Tax Court's decision in Moore v. Commissioner.[43] It distinguished Marcaccio v. Commissioner.[44]

(f) Tax Attribute Reduction

Applying the procedure in I.R.C. section 108(b)(4) for reducing tax attributes to the partners would require that:

- All reductions of partners' tax attributes are to be made after the determination of the partners' tax for the year of discharge.
- Reductions for partners' net operating loss and capital loss carryovers are to be made first in the loss for the taxable year of the discharge, and then in the carryovers to such taxable years in the order of the taxable years from which each carryover arose.

Credit carryovers (including foreign tax credits) of partners are to be made in the order in which the carryovers are listed in I.R.C. section 108(b)(2) for the taxable year of the discharge.

[42] 1994-1 C.B. 195.
[43] T.C. Memo. 1994-446.
[44] T.C. Memo. 1995-174.

These provisions allow a partner to exclude gains due to debt discharge from income and, before reducing partnership basis, to use net operating losses, certain credit carryovers, and capital loss carryovers to absorb all or part of the gain due to debt discharge. Thompson and Tenney suggest that these provisions make effective planning possible by allowing the partner to immediately use certain credit carryovers that would otherwise be taxed over a much longer time period.[45]

A partner with a $240,000 short-term capital loss carryover would, without any capital gains, be able to use only $3,000 per year. If this partner has an interest in a partnership having financial problems and if the other partners agree, a voluntary petition could be filed so that the partner's allowable share of the debt discharge could be used to reduce the capital loss carryover.[46] Otherwise, it would take 80 years to use up the capital loss carryover.

(g) Character of Debt

In order for a solvent, noncorporate partner who has not filed a petition under title 11 to reduce basis of depreciable property, the debt discharge must occur prior to January 1, 1987 and be in connection with property used in the partner's trade or business. It would appear that the character of the debt at the partnership level would be used to make this determination.[47] If this interpretation is in error, most limited, solvent partners in real estate and other investment partnerships would most likely be required to report the gain in income. At the partner level, the debt will probably not be considered a trade or business debt.

(i) Allocation to Passive Activities

According to Rev. Rul. 92-92,[48] income from discharge of indebtedness is generally characterized as income from a passive activity for purposes of I.R.C. section 469 to the extent that, at the time the indebtedness is discharged, the debt is allocated to passive activity expenditures and as income from a nonpassive activity to the extent that, at the time indebtedness is discharged, the debt is not allocated to passive activity expenditures.

Temporary Treas. Reg. section 1.163-8T provides that interest expense is generally allocated in the same manner as the debt to which the interest expense relates, for purposes of the passive loss limitation of I.R.C. section 469. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures.

The IRS has concluded that it is generally appropriate to allocate the income from debt discharge in the manner in which Temporary Treas. Reg. section 1.163-8T allocates the debt at the time of the discharge and to treat the income allocated to an expenditure as income from the activity to which the expenditure relates.

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[45] *Supra* note 3, at 108.
[46] *Id.*
[47] See Treas. Reg. § 1.58-2(b)(2) dealing with the investment interest limitations.
[48] 1992-45 I.R.B. 21. *See* Private Ruling 9522008, February 22, 1995.

The IRS also indicates that traditional substance-over-form and step-transaction principles will apply to prevent taxpayers from attempting to manipulate the character of the income from debt discharge.

In Rev. Rul. 92-92, the IRS provided the following example.

EXAMPLE 3.1

A, an individual, defaults on a recourse loan from an unrelated bank when the outstanding balance of the loan is $1 million. A transfers property with an adjusted basis of $700,000 and a fair market value of $800,000 to the bank in full satisfaction of the $1 million debt. As a result, A has $100,000 of gain on the sale ($800,000 value of property transferred less $700,000 of basis) and $200,000 of income from debt discharge ($1,000,000 liability discharged less $800,000 value of property transferred). I.R.C. section 108 does not exclude the income from debt discharge from A's gross income. At the time the indebtedness is discharged, under the rules of Temporary Treas. Reg. section 1.163-8T, 60 percent of the debt is allocated to passive activity expenditures and 40 percent of the debt is allocated to other expenditures. Thus, at the time A's loan is discharged, 60 percent of the debt is allocated to passive activity expenditures, and 40 percent is allocated to other expenditures. Thus, $120,000 (60 percent of the $200,000 COD income) is characterized as income from a passive activity, and $80,000 (40 percent of the $200,000 COD income) is characterized as income from a nonpassive activity.

The Bankruptcy Tax Act amended I.R.C. section 703 to provide a fifth exception to the requirement that the election affecting the computation of taxable income derived from a partnership is to be made by the partnership. The exception added provides that an election to reduce first depreciable property in a bankruptcy or insolvency case, or to reduce depreciable property in an out-of-court solvency situation involving qualified business indebtedness discharged prior to January 1, 1987, is allowed at the partner level.[49] This exception was added because of the requirement to apply the provision of I.R.C. section 108 at the partner level.[50]

(h) Reduction of Partnership Interest

I.R.C. section 1017(b)(3)(C) provides that a partner's interest in a partnership is to be treated as depreciable property to the extent of such partner's proportionate interest in depreciable property owned by the partnership. Thus, for a partner that elects to reduce basis in partnership interest, the partnership will be required to make a reduction in the basis of the partnership's assets with respect to that individual partner. This reduction would be made in a manner similar to that which would be required in a transfer of partnership interest when, under I.R.C. section 754, the partner made an election to reduce basis. Because this reduction is treated as a depreciation deduction, subsequent sale of the

[49] I.R.C. § 703(b)(2).
[50] I.R.C. § 108(d)(6).

partnership might result in ordinary income under I.R.C. section 1245.[51] It appears that if the partnership will not make the basis reduction, the partner cannot adjust Form K-1 to allow for this reduction and would have to report the gain as income or reduce the basis of other property.

The determination of a partner's proportionate share will not be difficult in simple partnership arrangements where the shares are consistent from year to year and are identical with respect to the different types and levels of profits and losses. There are, however, situations where complex profit and loss sharing arrangements exist, creating problems that will probably have to be resolved by regulation. Rabinowitz and Greenbaum make the following comments regarding the more complicated partnership arrangements:

> One such arrangement involves a shift of sharing ratios upon the occurrence of a certain event, e.g., the recovery by the limited partners of their investment. Another type of arrangement involves different ratios for sharing profit tiers among the partners. For example, a partnership agreement may provide that cash flow is to be distributed in the following order of priority: first to the limited partners an 8 percent preferred return on their investment, then to the general partner a 2 percent subordinated return on the investment of the limited partners, and the balance 80 percent to the limited partners and 20 percent to the general partner. How is one to determine any partner's share in the "depreciable property" held by such partnerships? Perhaps, the test should be based upon the extent to which a partner would share in the proceeds of a sale of depreciable property at the time the determination is made. This in turn may involve a valuation of that property. The task of those charged with drafting these regulations will not be an easy one.[52]

The election to treat a partnership interest as depreciable property is permitted only when a partner has an interest in a partnership having depreciable property. It would appear that it would not be necessary for the canceled debt to have been related to either the partnership or the partnership's interest, the basis of which is reduced.[53]

(i) Senate Committee Report

The following excerpt from the Senate committee report illustrates many of the points discussed above regarding the discharge of indebtedness of a partnership:

> For example, assume that a partnership is the debtor in a bankruptcy case which begins March 1, 1981,[54] and that in the bankruptcy case a partnership liability in the amount of $30,000 is discharged. The partnership has three partners. The three partners have equal distributive shares of partnership

[51] I.R.C. § 1017(d).

[52] Rabinowitz & Greenbaum, The Bankruptcy Tax Act of 1980: Partnership Considerations, 39 *Inst. on Fed. Tax'n* (NYU) 41-19 (1981).

[53] Berenson & Blank, The Bankruptcy Tax Act of 1980 (Part 1), 12 *Tax Adviser* 68, 77 (1981).

[54] The committee report was published prior to a subsequent change in the effective date of the various sections of this Act. Therefore, the March 1, 1981 date should be assumed to be a date subsequent to the effective date for the provisions of the Bankruptcy Tax Act of 1980.

income and loss items under section 702 (a) of the Code. Partner *A* is the debtor in a bankruptcy case; partner *B* is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner *C* is solvent, and is not a debtor in a bankruptcy case.

Under section 705 of the Code, each partner's basis in the partnership is increased by $10,000, i.e., his distributive share of the income of the partnership. (The $30,000 debt discharge amount constitutes income of the partnership for this purpose, inasmuch as the income exclusion rules of amended section 108 do not apply at the partnership level.) However, also by virtue of present law, each partner's basis in the partnership is decreased by the same amount (Code secs. 752 and 733). Thus, there is not [sic] net change in each partner's basis in the partnership resulting from discharge of the partnership indebtedness except by operation at the partner level of the rules of sections 108 and 1017 of the Code (as amended by the bill).

In the case of bankrupt partner *A*, the $10,000 debt discharge amount must be applied to reduce net operating losses and other tax attributes as specified in the bill, unless *A* elects first to reduce the basis of depreciable assets. The same tax treatment applies in the case of insolvent partner *B*. In the case of solvent partner *C*, such partner can elect to reduce basis in depreciable assets in lieu of recognizing $10,000 of income from discharge of indebtedness (providing the discharge occurred prior to January 1, 1987).

If *A*, *B*, or *C* elects to reduce basis in depreciable assets, such partner may be permitted, under the Treasury regulations, to reduce his basis in his partnership interest (to the extent of his share of partnership depreciable property), because the bill treats that interest as depreciable property. However, a partner may reduce basis in his interest in the partnership only if the partnership makes a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).[55]

(j) Exchange of Partnership Interest for Debt

I.R.C. section 108(e)(7)(F) provides that the Treasury will propose regulations dealing with the exchange of an interest in the partnership for partnership indebtedness. These proposed regulations are to be designed to provide for treatment similar to the issue of stock-for-debt. This section also provides that the regulations will deal with the subsequent sale of such interest in the partnership and how it will result in I.R.C. section 1245 income to the partner who was, at one time, a creditor.

Under existing law, the exchange of a partnership interest for debt will, however, have some tax consequences. Under I.R.C. section 752, the reduction in partnership liabilities as a result of the exchange of equity for debt will be treated as a distribution to the partners (other than the partner converting the debt). As a result of the distribution, each partner's basis in the partnership will be reduced. Because the financing is now by a related party, the application of the at-risk rules to the debt must be determined. The creditor under I.R.C. section 721 will most likely have a contribution of property in the form of the creditor's claim that should be tax-free. The basis of the former creditor's interest in the partnership will be the basis of the debt.

[55] *S. Rep. supra* note 8, at 22.

The IRS has indicated that it plans to resolve the issue of whether an equity-for-debt exception from cancellation of indebtedness income exists for partnerships.

I.R.C. section 108(e)(7)(E) indicates that Congress intended for there to be an exception for the exchange of interest in the partnership for partnership debt. There is no case law to support such an exception. It has been argued that the substitution theory of *Commissioner v. Capento Securities Corporation*[56] might apply to the partnership area. Another problem that the IRS must address is that there is no statutory insolvency or bankruptcy limitation to the exception as there is for corporations. Thus, should it be assumed that Congress contemplated a better deal for partnerships than for corporations?

Some suggest that I.R.C. section 721 would allow this exchange to be tax-free. The debt of the partnership is considered property for the purposes of I.R.C. section 721 in the hands of the transferor. One minor problem with this interpretation is that it is generally accepted that I.R.C. section 721 should be interpreted in a similar manner to I.R.C. sections 351 and 1032, which are its corporate analogues. Sheppard[57] points out that I.R.C. sections 351 and 1032 do not shelter the corporate stock-for-debt exchange—if they did, a special exception would be unnecessary—so why should the partnership analogue cover a partnership equity-for-debt exchange? However, I.R.C. section 351(d) indicates that a debt of the transferee is not property; however, there is no constraint in I.R.C. section 721 to indicate that debt is not property. In fact, I.R.C. section 351(d) was added by the Bankruptcy Tax Act of 1980, and no such provision was added to I.R.C. section 721.

Treas. Reg. section 1.721-1(b)(1) states that I.R.C. section 721 does not shelter a transfer in which a partner gives up any part of the right to be repaid its contributions in favor of another partner, in satisfaction of an obligation. Some would suggest that this regulation covers a transfer of an equity interest to a lender in satisfaction of a debt.

It can be argued that the application of this regulation is limited to the right to return of the partners' contributions (a right under the Uniform Limited Partnership Act [ULPA] that is routinely waived) and would not apply it to capital shifts.[58] Even if the regulation does apply to capital shifts, it is doubtful that a capital shift occurs when a new partner is admitted. Thus, the admission of a new partner by the issuance of partnership interest for the debt should restrict the application of I.R.C. section 721.

In the preamble to proposed Treas. Reg. section 1.108-2 dealing with related party debt, the IRS indicated its disagreement with the I.R.C. section 721 theory. However, the IRS promptly withdrew the suggestion that I.R.C. section 721 does not shelter partnership equity-for-debt exchanges, in Notice

[56] 47 B.T.A. 691 (1942), *nonacq.* 1943 C.B. 28, *aff'd*, 140 F.2d 382 (1st Cir. 1946).

[57] Sheppard, News Analysis: Problems Encountered in Real Estate Partnership Bankruptcies, 53 *Tax Notes* 1100 (Dec. 9, 1991).

[58] *Id.*

91-15.[59] There is considerable uncertainty as to what this notice means. It does indicate that in accounting for the exchange of an interest in the partnership for partnership debt, current law, whatever that may be, must be followed. It also implies that the parties to these exchanges are stuck with current law.

Under I.R.C. section 721, it can be argued that the amount of the debt canceled by the partnership equity interest should be limited to the fair market value of the latter. This interpretation is consistent with the aggregate theory of partnerships, which treats the partners as though they owned the partnership assets directly. Under this reasoning, a partnership interest cannot be worth more than its share of the underlying assets.[60]

Another option is to consider that the equity should result in the cancellation of an amount of debt that is equal to the partnership capital account assigned to it. Note that the partnership interest could be worth more than the partners' share of assets because the value of partnership interest, like the value of shares of stock, may differ from the net value of the assets.

The theory supporting the exclusion of the income from debt discharge under *Capento* would suggest that there should not be a limitation. The interest in the partnership should cancel the entire debt because the partnership interest could increase to be equal to the value of the debt that was canceled.[61]

Two other theories have been offered to justify an exclusion of the gain from income on the exchange of partnership debt for partnership interest.[62] First, Congress meant to include it in the Bankruptcy Tax Act of 1980 but failed to do so. Section 346(j)(7) of the Bankruptcy Code exempts equity-for-debt exchanges, including partnerships, from state and local taxes. This provision as drafted was to apply to federal taxes as well, but the federal tax provisions of the Bankruptcy Code of 1978 were removed in a congressional jurisdictional dispute and were included in the Bankruptcy Tax Act of 1980. The House Judiciary Committee certainly intended to include an equity-for-debt exception for partnerships. The Bankruptcy Tax Act did not contain such a provision. However, reference in I.R.C. section 108(e)(7)(E), dealing with I.R.C. section 1245 (recapture of bad debt deductions when creditors sell equity interests received in exchange for debt), authorizes the Treasury Department to issue regulations to explain how this provision would apply to partnerships. A rule of this nature was needed only if Congress assumed there was a partnership exception.

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[59] 1991-22 I.R.B. 27.

[60] Sheppard, *supra* note 57.

[61] Glenn R. Carrington, IRS assistant chief counsel (Income Tax and Accounting), stated at a December 1991, Washington (DC) Bar meeting that he did not think that I.R.C. section 721 alone would provide statutory support for a partnership exception. He noted that the IRS, in Rev. Rul. 90-87, 1990-2 C.B. 32, rejected an analysis based on I.R.C. section 1032, which is the corporate analog to I.R.C. section 721, by capping the amount of the stock-to-debt exception at the amount of the liquidation preference of preferred stock.

[62] Sheppard, *supra* note 57.

Second, the case law notion of substitution supports the exclusion of an exchange of debt for an interest in the partnership. The substitution idea is primarily derived from *Capento.*[63] Other cases, none of which deals with partnerships, also support this exclusion.[64]

Several partnership tax questions were dealt with in the prepackaged bankruptcy of the Trump Taj Mahal Casino-Resort. Trump Taj Mahal Associates is a partnership that owns the Taj Mahal. Taj Mahal Associates sold $675 million in 14 percent cash-pay bonds to the public through a nominee corporation, Taj Mahal Funding Corp. The arrangement was devised so that the bondholders would not have to qualify as casino operators. The bonds were secured by the mortgage on the Taj Mahal Casino. A note and a guarantee from the Taj Mahal Associates to Taj Mahal Funding Corp. mirrored the terms of the bonds. A prepackaged bankruptcy plan was negotiated with the larger bondholders when Trump was unable to make the interest payments.

Under the prepackaged plan, the bondholders received, in exchange for their 14 percent bonds, new bonds having the same terms as the old bonds but paying a lower interest rate on a principal amount enlarged by accrued interest, and half of the equity of the Taj Mahal Associates, which they could not own directly according to New Jersey gambling law. Only Taj Mahal Associates (a partnership) and its officers are licensed to own and operate a casino. Effective control of the partnership now rests with a newly created holding company, Taj Mahal Holding Corp., whose equity and board seats are shared by the bondholders and Trump. The partnership was converted from a limited partnership to a general partnership whose three corporate general partners are controlled equally by Taj Mahal Holding Corp. and Trump. Before the reorganization, the partners were two corporations wholly owned by Trump.

One question that had to be answered was whether the issuance of stock on behalf of the debtor qualified under I.R.C. section 108. In the disclosure statement issued by Taj Mahal, it was reported that, although Taj Mahal Holding Corp. issued the equity and Taj Mahal Funding Corp. issued the new bonds received by the bondholders, the partnership was the real obligor on the original bonds.[65] The conclusion was then reached that, under I.R.C. section 721, there was no income from the debt discharge on the exchange.

(k) Abandonment of Partnership Interest

At times, a partner would like to abandon a partnership interest in order to obtain an ordinary loss rather than a capital loss. A partner who abandons property and is not relieved of any debt should recognize an ordinary loss for the

[63] *Supra* note 56.

[64] Sheppard notes that "[t]he reasoning in the cases concerning corporate equity-for-debt exchanges is so weak that tax experts do not believe that it even supports the result obtained in the cases themselves, but Congress has accepted this result nonetheless (although the stock-for-debt exception narrowly escaped repeal in 1990)." 53 *Tax Notes* 1100.

[65] *See Commissioner v. Bollinger*, 485 U.S. 340 (1988).

amount of his or her adjusted basis in the partnership. In *In re Kreidle*,[66] a partner who was also a debtor in bankruptcy recognized an ordinary loss for worthless partnership interest where the partner remained liable for the debt and received no distributions from the failed partnership. Earlier courts have held that an abandonment is treated as a sale or transfer. (See § 2.8(d) for a discussion of these cases.) Abandonment may be difficult in cases where the partner is personally liable for the debts of the partnership.

Treas. Reg. section 1.165-1(b) provides that a loss is allowable only if evidenced by a closed and completed transaction, fixed by identifiable events, and sustained during the taxable year. In *Echols v. Commissioner*,[67] the Fifth Circuit determined that a refusal by a general partner to make additional payments on partnership nonrecourse debt was adequate enough to constitute an abandonment of the partnership interest. The court also determined that the facts supported an alternative worthlessness deduction under I.R.C. section 165(a).

Under I.R.C. sections 731, 741, and 752, a partner who is relieved of debt as a result of the abandonment will recognize a capital loss only to the extent of the adjusted basis in excess of the amount of the liabilities that are canceled.

A partner in bankruptcy may find that an interest in a partnership has been abandoned without any action by the partner. For example, in *In re Nevin*,[68] the bankruptcy court ordered the trustee to abandon to the debtors their respective partnership interests in the limited partnerships. The order came after the IRS filed a motion for abandonment. The limited partnership filed a chapter 7 petition and ceased operating its restaurant. The bankruptcy court approved the sale of the restaurant, which resulted in a federal tax liability of approximately $100,000 to the partners.

The partners are in chapter 7 in a "no asset" case, and there are no funds in the estates of the individuals to pay the tax liability, but there are funds in the partnership to pay the taxes.

The impact of an abandonment on I.R.C. section 469 is unclear. It could be argued that an abandonment is an event that would trigger the use of suspended losses under I.R.C. section 469. Courts have held that forgiveness may occur when the creditor has abandoned the debt collection efforts in a case where the debt was not discharged.[69]

(l) Impact of Partner Bankruptcies

A transfer of a partnership interest of an individual in bankruptcy to the bankruptcy estate does not result in a disposition for federal tax purposes under I.R.C. section 1398(f) and for state and local tax purposes under I.R.C. section 346(g)(1)(A). Likewise, a transfer of 50 percent or more of the interest in a

[66] 91-2 USTC (CCH) 50,371 (Bankr. D. Col. 1991).
[67] 935 F.2d 703 (5th Cir. 1991).
[68] 135 B.R. 652 (Bankr. D. Hawaii 1991).
[69] *See Cozzi v. Commissioner*, 88 T.C. 435 (1988); *Carlins v. Commissioner*, 55 T.C.M. (CCH) 228 (1988).

partnership by an individual to his or her bankruptcy estate will not terminate the partnership interest under I.R.C. section 708.[70]

There is some uncertainty as to the impact that nontermination of the partnership interest for tax purposes will have on allocations (gains, losses, and so on) in the year of the discharge.

Based on I.R.C. section 1398(f), the IRS, in a Private Letter Ruling,[71] held that all items of gain, loss, deduction, or credit for the entire year in which the petition is filed are allocable to the bankruptcy estate.

Other commentators have suggested that the estate's gains, losses, and so on, should be allocated both to the individual and to the estate. For example, it can be argued that to *not* consider the tax on income earned as a prepetition tax is in opposition to the legislative history for I.R.C. section 1398(d)(2).[72] The fact that the transfer of the property to the estate is not a disposition does not automatically lead to the conclusion that the debtor and the estate cannot both have an interest in the pass-through items for the year in which the petition is filed. Malek notes, regarding a partnership pass-through entity, "although it is admitted that the non-disposition status of the transfer probably would put it beyond the reach of I.R.C. section 706(c)(2), it should not put it beyond the reach of I.R.C. section 706(d), which is triggered when there is a mere 'change' in a partner's interest."[73]

§ 3.3 S CORPORATIONS

The number of S corporations that filed chapter 11 petitions or attempted an out-of-court workout increased significantly during the late 1980s and early 1990s.

(a) General Provisions

Under I.R.C. section 61(a)(12), the S corporation has income from the cancellation of its debts unless excluded from income under the provisions of I.R.C. section 108. Any income that does not qualify for a section 108 exclusion loses its character as income from debt discharge in the case of an S corporation. This income is combined with other profits and losses and passes through to the shareholders. If the income from debt discharge arose from passive activities, that income would pass through to the shareholders as a part of the profit or loss from passive activities. If the debt arose for activity in a trade or business, then the income would be part of the S corporation's trade or business profit or loss, which is passed through to the shareholders. Shareholders who receive the income will in turn increase their basis in their stock under I.R.C. section 1367(a)(1). Because the income from debt discharge cannot be distributed, it will increase the S corporation's accumulated adjustment account (AAA) under I.R.C. section 1368(e)(1)(A).

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[70] See Rev. Rul. 68-48, 1968-1 C.B. 301 and I.R.C. § 1398(f).
[71] Private Letter Ruling 9304008 (Oct. 27, 1992).
[72] H.R. REP. NO. 833, 96th Cong., 2d Sess. 21 (1980).
[73] Malek, Comments on Proposed Regulations under Section 1398 (Communication to IRS from Association of Insolvency Accountants, Jan. 11, 1993), p. 3.

The bankruptcy court held that an individual debtor was entitled to passthrough losses from an S corporation, regardless of whether he transferred his stock to a trust.[74] The bankruptcy court rejected the Service's position that the taxpayer ceased to be a shareholder when he transferred shares to the trust. According to the bankruptcy court, the trust agreement supported Forte's assertion that the trust may be a shareholder under I.R.C. section 1361. The court determined that because the taxpayer was taxed on the trust's income under section 671, the corporation did not lose its status as an S corporation.

The court did, however, agree with the Service that the adjusted basis had to be reduced.

(b) Responsibility for Filing Corporate Returns

The debtor-in-possession or trustee, if one is appointed, is responsible for filing the corporate tax return. Under I.R.C. section 1399, a separate estate is not created for federal income tax purposes when a corporation files a bankruptcy petition.

Even though income is not taxed at the corporate level in the case of an S corporation, there is no indication that the responsibilities for filing an S corporation return are different from those for filing a return of a C corporation. (For a discussion of the responsibility for filing corporate returns, see § 7.26.) However, it could be argued that the responsibility for filing an S corporation return is similar to that of a partnership. Both entities pass-through income and losses to the owners—either partners or shareholders. (For a discussion of the responsibility for filing a partnership return, see § 3.2(b).)

The National Office of the IRS issued a "policy statement" change indicating that it would issue prompt determination letters only on returns for which there is a tax liability. The Service no longer issues determination letters for S corporations. However, it is still advisable for the debtor to request such a letter and properly document the request. For example, in *In re First Securities Group of California, Inc.*,[75] the bankruptcy court considered the request valid over the objection of the IRS. See § 10.3(a) for a discussion of this case.

(c) Tax Attribute Reduction

I.R.C. section 108(d)(7), as amended by the Tax Reform Act of 1984, provides that attributes are to be reduced and the income from debt discharge is to be handled at the corporate level under the following conditions:

- The S corporation files a title 11 petition.
- The S corporation is insolvent (or to the extent that insolvency exists).
- In an out-of-court workout under I.R.C. section 108(g), the S corporation qualifies for attribute reduction due to "qualified farm indebtedness."

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[74] *In re Michael Forte*, 234 B.R. 607; 99-1 U.S. Tax Cas. (CCH) P50, 568 (Bankr. E.D.N.Y. 1999).
[75] SIPA No. LA 92-01156 KM (Bankr. C.D. Cal. Oct. 7, 1997).

I.R.C. section 108(d)(7) applies as if it had been included in the Subchapter S Revision Act of 1982, and it is applicable to tax years beginning after December 31, 1982. I.R.C. section 1363(c)(2)(A), which provided for the discharge to be applied at the shareholder level, was thus repealed.

In the case of an S corporation, the attributes that can be reduced may be limited. Often, an S corporation has no net operating losses because all profits and losses are recognized at the shareholder level. I.R.C. section 108(d)(7)(B) provides that any loss or deduction that is disallowed because it exceeds the shareholder's basis in stock and indebtedness of the S corporation is treated as a net operating loss for such taxable years. If the S corporation has net operating losses that still exist from the period in which the corporation was a C corporation, such losses would be an attribute that is subject to basis reduction.

(d) Exceptions

There are several exceptions and modifications to the basic income from debt discharge rules. They include the following:

- I.R.C. section 108(e)(6) provides that, if a corporation acquires its indebtedness from a shareholder as a contribution to capital, the corporation will be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the debt. However, for S corporations, I.R.C. section 108(d)(7) provides that a shareholder's adjusted basis in the indebtedness of an S corporation is to be determined without regard to any adjustments that have been made under I.R.C. section 1367(b)(2). For example, assume a shareholder of an S corporation has a claim for $10 and the basis for the debt is $3 less, because of a prior loss pass-through. If the shareholder agrees to cancel the entire claim as a contribution to capital, the S corporation will not have any income from debt discharge.
- Under I.R.C. section 108(e)(5), a reduction of a purchase money debt owned by an S corporation that is solvent and has not filed a bankruptcy petition is considered basis reduction and not income from debt discharge, provided the adjustment is between the original buyer and seller of the property. Note that this applies only to modifications made between the original buyer and seller.
- Under I.R.C. section 108, income from debt discharge will not be recognized to the extent that payment of the liability would have given rise to a deduction. Thus, the settlement of a liability by an S corporation on the cash basis, or the cancellation of contested or contingent liability, does not generally give rise to income from debt discharge.
- Eustice[76] indicates that, if debt is acquired by a related party as defined under I.R.C. sections 267(b) and 707(b), then I.R.C. section 108(e)(4) treats the debt as immediately discharged "to the extent provided in regula-

[76] Eustice, Financially Distressed S Corporations, 53 *Tax Notes* 97, 99 (Oct. 7, 1991).

tions," and Proposed Treas. Reg. section 1.108-2(a) treats the transaction acquiring the debt as an immediate deemed discharge of the old debt at its fair market value. Proposed Treas. Reg. section 1.108-2(e)(1) provides for a deemed new issue of that debt at its then-value. Thus, an original issue discount (OID) is created by both the S corporation and the related holder.

(e) Impact on Shareholder

I.R.C. section 1366(d) provides that a shareholder may not deduct losses and deductions in excess of his or her basis in stock plus the amount owed by the S corporation to the shareholder.

I.R.C. section 1366(a)(1)(A) provides that the shareholder's basis in stock must be adjusted by the shareholder's share of the corporation's items of income (including tax-exempt income), loss deduction, and so on. I.R.C. section 108(b)(4) provides that the reduction of tax attributes must be made after the determination of the tax for the taxable year of the discharge. The reduction of tax attributes is made first for the loss for the taxable year of the discharge and then for the losses carried forward. Thus, it would appear that (1) the increase in stock basis resulting for the income from debt discharge and (2) the utilization of suspended losses occur before any attribute reduction under I.R.C. section 108. Any reduction in the basis of property is made as of the first day of the taxable year after the discharge occurs.

As noted above, income from debt discharge will not be included in gross income; instead, tax attributes will be reduced at the S corporation level. There are two basic theories as to the impact of the income from debt discharge on the shareholder's basis in the stock. The position probably followed most in practice suggests that the shareholder has a stepped-up basis. The second position suggests that the basis is not stepped-up.

The Supreme Court in *Gitlitz v. Commissioner*,[77] reversed a decision of the Tenth Circuit and held that income from the discharge of debt is an item of income that passes through to shareholders, increasing their stock basis. The Court also held that the increase occurs before they are required to reduce the tax attributes in the S corporation. The original interpretation by most of the leading commentators is consistent with the ruling by the Supreme Court. However, the Service, in an effort to close what it considered a tax loophole, attempted in vain to get the Supreme Court to look at the equity of the issues rather than focusing on the wording of the statute.

However the right shareholders of S corporations had to increase their basis due to income from debt discharge that lasted for only a short-time period. On March 9, 2002, President Bush signed the Job Creation and Worker Assistance Act of 2002 providing that income from debt discharge by an S corporation was excluded from the tax exempted items, overruling the decision of the Supreme Court in *Gitlitz*. The amendment applies to discharges of indebtedness after October 11, 2001, in taxable years ending after such date. The amendment made by this section did not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

[77] 121 S. Ct. 701 (2001).

Prior to the Supreme Court decision, the Tenth Circuit decided in two cases of first impression in 1999 that shareholders of an insolvent S corporation did not have an increase in the basis of their stock as a result of the corporation's excludable COD income.[78]

The reasoning of the Court, as stated in *Gitlitz*, was that in order for the shareholders to avoid a windfall, attribute reductions preceded the pass-through of COD to the shareholders. "Shareholder's pro rata share of the corporation's net operating losses passes through to him only to the extent such losses are not absorbed by the shareholder's pro rata share of the excluded canceled debt," because such losses have effectively been borne not by the shareholder, but by the corporation's creditors. As noted above the Supreme Court reversed the Circuit Court's decision.

Additional cases in 2000 held in favor of the taxpayers,[79] including one in the District Court of Oregon (*James D. Hogue v. United States*), one in the Third Circuit (*United States v. Harold D. Farley*), one in the Seventh Circuit (*William C. Witzel v. Commissioner*), and one from the Eleventh Circuit (*Pugh v. Commissioner*).

The Service, in an effort to reverse the trend developing to allow the stepped-up basis, recently issued regulations concluding that tax-exempt income does not include income from discharge of indebtedness excluded from income under section 108 because such income is not permanently excludible from income in all circumstances in which section 108 applies.[80]

Earlier, in attempts to limit the increase in basis at the shareholder level, the Service issued a Private Letter Ruling,[81] ruling that the discharge of indebtedness income that is excluded from gross income under I.R.C. section 108(a) does not pass through to S corporation shareholders as a separately stated item of tax-exempt income under I.R.C. section 1366(a)(1) and as a result does not increase shareholders' stock basis under section 1367.

(f) Impact of Termination

An S corporation may be terminated as a result of the bankruptcy proceeding for several reasons. Among them are:

- Another class of stock is issued, such as preferred stock.
- Stock is issued to an impermissible new shareholder.
- Shareholders' holdings are in excess of the maximum shares allowed.
- The S corporation is liquidated.

[78] *Gitlitz v. Commissioner of Internal Revenue*, 182 F.3d 1143, 1148 (10th Cir. 1999) and *Mel T. Nelson v. Commissioner*, 98-9014, 182 F3d 1152 (10th Cir. 1999).

[79] *James D. Hogue v. United States*, 85 AFTR 2d Par. 2000334 (D.C. Oregon, 2000; *United States v. Harold D. Farley*, 202 F.3d 198 (3rd Cir. 2000), *Gaudiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000), *Pugh v. Commissioner*, 213 F.3d 1324 (11th Cir. 2000), and *William C. Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000).

[80] Treas. Reg. § 1.1366-1(a)(2)(viii), 64 Fed. Reg. 71641, 71643 (Dec. 22, 1999).

[81] Private Letter Ruling 9423003 (February 28, 1994). *See* Private Letter Ruling 9541006 (July 5, 1995) for a similar ruling.

The termination occurs as of the date of the terminating event. If a plan that calls for stock to be issued to creditors would create more than 35 stockholders, the terminating event would be the confirmation of the plan by the court.

The Service has granted a former S corporation's request for a waiver of the five-year waiting period for reelecting S status.[82] The company lost its S election because in a shareholder's bankruptcy, the shares of stock were transferred to a trust that was a nonqualified shareholder. After the transfer, the company filed income tax returns as a C corporation. The company subsequently purchased the shares from the trust and then filed a request for relief with the IRS.

The Ninth Circuit Bankruptcy Appellate Panel held that the revocation of a corporation's subchapter S election prior to the filing of a chapter 7 petition is a transfer that the trustee may avoid under section 548 as a fraudulent transfer.[83]

Craig Saunders and his wife own all the stock of Bakersfield Westar Inc., which provided air and ground ambulance services to the residents of Kern County, California. They filed an S corporation election at the beginning of 1992, and on February 1, 1994, that election was revoked by the taxpayers. Fourteen days later the taxpayers filed a chapter 7 petition. The chapter 7 trustee filed a voluntary chapter 7 petition for Bakersfield. The trustee for Bakersfield filed action against the Saunderses and their trustee and the IRS to avoid the revocation of the S corporation status as a fraudulent transfer under section 548 of the Bankruptcy Code. The bankruptcy court ruled that the revocation was not a transfer by the corporation of property or a property interest. The chapter 7 trustee for Bakersfield appealed.

On appeal, the IRS argued that the right to revoke a subchapter S election under section 548 of the Bankruptcy Code is not an interest of the debtor in property because the right has no present value. The Ninth Circuit Bankruptcy Appeals Panel (BAP) rejected the argument of the Service noting that the Service's argument unduly limits the definition of property and held that the right has value to a debtor's estate and is therefore properly characterized as property. The court cited *Begier v. IRS*,[84] holding that section 541 includes all the debtor's legal or equitable interests in the definition of property of the debtor and *In re Trans-Lines West Inc.*,[85] holding that a corporation's right to use and dispose of its subchapter S status is property because it is a right guaranteed by I.R.C. section 1362(c).

The court concluded that the ability not to pay taxes has value, because of the subchapter S revocation, Bakersfield will be taxable on approximately $400,000 in capital gains that without the revocation would have been taxable to its shareholders. This action reduced the funds available for distribution to Bakersfield's creditors.

Once the Ninth Circuit BAP concluded that the right to revoke the election is property, the court then held that the revocation is an avoidable transfer under

[82] Private Letter Ruling 9537006 (June 14, 1995).
[83] *In re Bakersfield Westar Inc.*, 226 B.R. 227 (BAP 9th Cir. 1998).
[84] 496 U.S. 53 (1990).
[85] 203 B.R. 653 (Bankr. E.D. Tenn. 1996).

section 548(a) of the Bankruptcy Code. This conclusion by the Ninth Circuit BAP follows *In re Russell,*[86] which held that an irrevocable transfer under the I.R.C. constitutes a transfer for purposes of the Bankruptcy Code. The Ninth Circuit noted that the election, an issue in *In re Russell,* was an election to carry over a net operating loss under section 172. However, the bankruptcy court in *In re Trans-Lines* followed *In re Russell,* even though the issued involved a subchapter S election. The Ninth Circuit BAP found no significant difference between the two elections for avoidance purposes. The court was unpersuaded by the IRS's claim that allowing trustees to avoid otherwise irrevocable elections would create administrative havoc.

(g) Debt Modifications and Restructurings

An S corporation in financial difficulty may attempt to resolve its financial problems by reducing the interest rate, stretching out the terms, issuing equity interest for the debt, or some combination of those methods. The tax issues that are raised when the debt is restructured are similar to those raised by a C corporation (see Chapter 2). For example, if the face amount of the new debt is at least equal to that of the old debt and the stated interest rate is adequate, there will be no income from debt discharge to the corporation unless the debt is publicly held, which is unlikely in the case of an S corporation.[87]

However, a few issues are unique to an S corporation. The issuance of stock may result in the termination of the S corporation for several reasons, including the issuance of stock to too many shareholders and the issuance of a debt security that might be reclassified as equity under I.R.C. section 385, thus creating a second class of stock. To avoid the termination of the S corporation status by the issuance of shares to creditors, thereby creating too many shareholders, the issuance of debt for stock is often restricted to selected large debt holders or creditors that are also shareholders. An S corporation, by not issuing stock for at least some of its debt, may see the basis of its assets reduced materially, which will impact future deductions. If stock had been issued that was not de minimis under I.R.C. section 108(e)(8) or disqualified stock under I.R.C. section 108(3)(10), tax attributes—including the basis in property of the debtor—would not have been reduced.

The requirements of I.R.C. section 385 might especially be a problem if the debt was held by a shareholder. Thus, in issuing stock for debt held by a shareholder, the transaction needs to be carefully constructed. For example, the issuance of the equity might be evidence that the debt held by the shareholders was in fact disguised equity, meaning that the S corporation status has already been terminated.

The S corporation would need to be careful in the issuance of stock purchase options or warrants for debt. The IRS has traditionally taken the position that warrants are not stock for purposes of subchapter C but are boot for purposes of

[86] 927 F.2d 413 (8th Cir. 1991).
[87] I.R.C. §§ 1273 and 1274.

I.R.C. sections 351, 354, and 355.[88] However, Treas. Reg. section 1.1361-1(1)(4)(iii) considers deep-in-the-money options as stock; thus, two classes of stock may exist, terminating the S corporation status.

(h) Reorganization under Section 368

Any reorganization under I.R.C. section 368(a)(1), such as a "G" reorganization that involves a mandatory liquidation of the old corporation, will result in the termination of the S corporation status. The general provisions of a tax-free reorganization that apply to a C corporation will apply to the S corporation. For example, assume a reorganization qualifies as tax-free under I.R.C. section 368(a)(1). Under I.R.C. section 361, no gain or loss will be recognized on the assets transferred and, generally, no gain or loss will be recognized on the liquidating distributions made by the acquirer.

Shareholders that do not receive any interest in the new corporation, or other forms of consideration, will most likely have a worthless stock deduction—a capital loss, unless the stock is considered section 1244 stock. According to I.R.C. section 1367(b)(3), any basis adjustment under this section and any pass-through items under I.R.C. section 1366 are to be applied before losses are recognized under I.R.C. sections 165(g) and 166(d). Upon the elimination of the shareholders' interest, any suspended loss carryovers would terminate.

Shareholders that receive stock in the acquiring corporation would qualify for the nonrecognition treatment under I.R.C. section 354. The old shareholders' AAA shares and any I.R.C. section 1371(e) rights would not carry over into the stock of the acquiring C corporation.[89]

Most likely, these attributes would carry over if the acquiring corporation was an S corporation. It would appear that the suspended shareholder losses and the benefits of I.R.C. section 1366(d)(3) (carryover of disallowed losses and deductions to a post-termination transition period) would not carry over to the acquiring S or C corporation because both provisions apply to the stock of the original loss-generating S corporation.

The impact of a reorganization on the creditors of an S corporation will not differ from the impact on those of a C corporation.

The Service ruled that the restructuring of an S corporation in a bankruptcy will qualify as a tax-free reorganization under section 368(a)(1)(G).[90] The S corporation was in default on two of its issues of subordinated notes. In order to restructure the corporation and rehabilitate its business, it planned to file a plan of reorganization under chapter 11, where the S corporation would form a C corporation, Newco, that would merge into it. In exchange for all of their notes, interest, and claims, the noteholders of the S corporation would receive 95 percent of the Newco stock. The S corporation shareholders were to receive 5 percent of Newco stock in exchange for their shares.

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[88] *Supra* note 76, at 103.

[89] *See* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (5th ed. 1987), para. 6.08A, para. 2 (current supplement).

[90] Private Letter Ruling 9629016 (July 19, 1996).

The Service ruled that the merger would qualify as a "G" reorganization, and as a result there would be no gain or loss recognized by the S corporation or Newco as a result of the transfer of assets and distribution of Newco stock. The Service ruled that to the extent that the adjusted issue price of the S notes exceeds the fair market value of the Newco stock received by the noteholders, the S corporation would realize cancellation of indebtedness income based on Treas. Reg. section 1.61- 12(c)(3). However, since the S corporation was in bankruptcy, the COD income realized would be excludable from gross income under section 108(a)(1)(A) in the corporation's final S corporation year. Newco would reduce its attributes under section 108(b)(2) in an amount equal to the discharged and excluded COD income. The Service ruled that any loss or deduction disallowed under section 1366(d)(1) will be treated as a net operating loss for the tax year of discharge under section 108(d)(7)(B), but that the COD income neither passes through nor increases the shareholders' bases in their S corporation stock under section 1367(a).

(i) Liquidations

An S corporation that liquidates incurs no unusually negative tax consequences. In a case of debt discharge, liquidation may have an advantage to shareholders, as discussed above.

Any gain or loss on the sale of the assets will be passed through to the shareholders. If there are any I.R.C. section 1374 built-in gains that may have adverse tax consequences, they are handled at the corporate level. Thus, they become a liability of the corporation and will, in case of a bankruptcy proceeding, receive payment before unsecured creditors. However, when there are no free assets, as is often the case, the tax liability will remain unpaid.

The shareholders will most likely not receive any proceeds from the liquidation, but they may have taxable income from the gains that pass through and deductible losses on the pass-through losses incurred, provided there is sufficient basis to absorb the losses.

Any income from debt discharge is reflected at the corporate level and not taxed to individual shareholders, but the shareholders may have the opportunity to increase their basis as a result of the debt discharge, as discussed above.

(j) Bankruptcy Estate

When the S corporation files its bankruptcy petition, a new estate is created for bankruptcy purposes; however, a new entity is not created for tax purposes. The S corporation will continue to file its tax return in the same manner as before. However, the requirements for an S corporation continue, and if any of the provisions for the termination of the S corporation are not satisfied, the S corporation status will be terminated.

(k) Shareholder Bankruptcy

I.R.C. section 1361(c)(3) provides that the estate of an individual that is in bankruptcy is a qualified shareholder for an S corporation.

I.R.C. section 1377(a)(1) provides that income and losses from an S corporation are to be allocated among the shareholders based on the number of days that each held an interest in the S corporation, unless the shareholders elect to terminate the taxable year. No specific reference is made to the method of allocation when an interest is transferred to the bankruptcy estate. It is often assumed that the income and profits should be prorated based on the time (number of days) each held an interest in the S corporation.

Under I.R.C. section 1377(a)(2), in order to terminate the taxable year as of the date when the chapter 7 or chapter 11 petition is filed, all persons who are shareholders during the taxable year must agree to the election to terminate the taxable year. If a trustee has been appointed where a shareholder has filed a chapter 7 or chapter 11 petition, the trustee would most likely not agree to the termination if it would be disadvantageous to the estate. Furthermore, in a chapter 11 case where the debtor remains in possession, the court might be reluctant to accept or might even overturn such an election if one was made.[91]

Based on I.R.C. section 1377(a)(2), it appears that the election must be made only if there has been a termination of the shareholders' interest. There is some question as to whether the transfer of the stock to a bankruptcy estate, especially in a chapter 11 case, would constitute a termination of shareholder interest.

(l) Shareholder Guarantee

In *Lamar and Norma K. Hunt v. Commissioner*,[92] the Tax Court held that income from debt discharge is included in the income of the debtor and not that of the guarantee. This ruling is consistent with I.R.C. section 108(e)(2). As noted above, income is not realized if payment of the liability would have given rise to a deduction. If the guarantee had been required to make the debt payment, a deduction for bad debt would most likely have been reported.

Mathias[93] notes that there is little authority on who reports income from cancellation of a joint and several liability. The income might be reported by the party who receives the original proceeds from the loan or it could also be argued that the income from debt discharge should follow the taxpayer who will ultimately bear the economic burden. In *Bressi v. Commissioner*,[94] the Tax Court held that, in a case where a shareholder borrowed money for the development of personally owned property, the shareholder must report the income from debt discharge even though a wholly owned subsidiary was jointly and severally liable for the debt.

[91] *See In re Russell*, 927 F.2d 413 (8th Cir. 1991), where the trustee's avoidance powers under the Bankruptcy Code were allowed to avoid an irrevocable election under I.R.C. § 172(b)(3)(C) to carry forward a taxpayer's net operating losses.

[92] 59 T.C.M. (CCH) 635 (1990).

[93] *Tax'n for Law*. 234, 238 (January/February 1993).

[94] 62 T.C.M. (CCH) 1668 (1991), *aff'd without opinion*, 1993 U.S. App. LEXIS 5320 (3d Cir. 1993).

CHAPTER FOUR

Taxation of Bankruptcy Estates and Debtors

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§ 4.1 INTRODUCTION

The procedure for filing tax returns for corporations is well established; however, much controversy existed in the past over the types of returns to file for individuals and partnerships. To eliminate some of the uncertainty as to whether a separate entity was created, the Bankruptcy Tax Act added sections 1398 and 1399 to the Internal Revenue Code (I.R.C.).

The objective of this chapter is to discuss the provisions of I.R.C. section 1398 that impact both the bankruptcy estate and the debtor. The state and local tax provisions contained in the Bankruptcy Code that impact the bankruptcy estate and the debtor will be described in Chapter 8.

§ 4.2 RESPONSIBILITY FOR FILING INCOME TAX RETURNS

(a) Prior Practice

Prior to the Bankruptcy Tax Act of 1980, the IRS took the position that for individuals and partnerships the bankruptcy estate was a new taxable entity. Therefore, the trustee was required to file fiduciary tax returns.[1] Conversely, the courts had generally ruled that a trustee in a liquidating bankruptcy case was not required to file tax returns on behalf of either the debtor or the bankruptcy estate.[2] However, in *In re 4100 North High Limited et al.,*[3] the court held that the tax imposed on an estate under I.R.C. section 641 was not applicable to bankruptcy estates. One trustee, however, was liable for all federal, state, and local taxes in a liquidation proceeding by virtue of 28 U.S.C. section 690, which provides that any court officer or agent who conducts business under court authority is liable for these taxes. The court further held that the trustee should compute the tax based on corporate and individual rates and pay whichever amount is smaller.

For situations where the business continues in existence, the IRS earlier ruled that a separate taxable entity is created.[4] This ruling considered the issue of whether an S corporation would lose its S status if one of its shareholders filed for bankruptcy in Chapter XII. The IRS held that, with Chapter XII proceedings, an estate was created that (1) was a separate taxable entity and (2) served to disqualify the corporation's S election. However, the Tax Court did not follow this ruling in *CHM Co. v. Commisioner.*[5] The court held that an individual in either Chapter XI or XII bankruptcy proceedings does not create an entity apart from the individual debtor. Therefore, the bankrupt shareholders of an S corporation did not cause the corporation to lose its S status. Further support for this position was found in *In re Lister,*[6] where the court ruled that a receiver appointed

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[1] Rev. Rul. 68-48, 1968-1 C.B. 301; Rev. Rul. 72-387, 1972-2 C.B. 632.
[2] *In re Siehl*, 76-1 USTC (CCH) 9217 (S.D. Ohio 1973); *In re Kirby*, 62-2 USTC (CCH) 9752 (S.D. Tex. 1962).
[3] 80-1 USTC (CCH) 9454 (S.D. Ohio 1980).
[4] Rev. Rul. 74-9, 1974-1 C.B. 241.
[5] 68 T.C. 31 (1977).
[6] 177 F. Supp. 372 (E.D. Va. 1959).

for a partnership in a Chapter XI case was not required to file a separate fiduciary tax return.[7] This applied to both an individual and a partnership. I.R.C. sections 1398 and 1399 were passed to eliminate the conflict.

(b) Current Practice

A trustee that fails to file a return and pay the taxes may be held liable for such taxes. I.R.C. section 6012(b)(4) was amended by the Bankruptcy Tax Act of 1980 to provide that "[returns] of an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code shall be made by the fiduciary thereof." In *In re Joplin, Jr.*,[8] the Tenth Circuit held that the trustee had the responsibility to file a tax return even though the Internal Revenue Code provided (under I.R.C. section 6012 as existed prior to the 1980 amendments) that the trustee for a corporation in bankruptcy had a duty to file the returns but was silent with regard to the responsibility of a trustee for an individual. In *Joplin*, the IRS instituted an adversary proceeding in the bankruptcy court against State Farm, the trustee's surety, seeking recovery of the unpaid tax. Both the bankruptcy court and the district court ruled against the IRS. The Tenth Circuit reversed the decision of the district court, vacated the dismissal of the claim against State Farm, and remanded the matter to the district court for further proceedings.

Relating to chapter 7, section 706 of the Bankruptcy Code requires the trustee, if authorized to operate the business, to file with the governmental unit charged with responsibility for collecting or determining any tax arising out of such operation. In *In re Harry Fondiller,*[9] the bankruptcy court noted that, in a chapter 7 case, the trustee is charged with the responsibility of preparing and submitting to the IRS tax returns based on section 728(b) of the Bankruptcy Code. The court also noted that I.R.C. section 1398(c) requires that the trustee pay the tax incurred by the estate. The court went on to note that, if the tax is not paid on or before the due date, I.R.C. section 6601(a) indicates that interest shall be paid from the due date until the date the tax is actually paid.[10]

Section 1106 of the Bankruptcy Code indicates that the trustee is responsible for filing a tax return for any year in which the debtor has not filed a tax return that is required by law. This return is to be furnished without personal liability and must include the information that is required by the governmental unit with which the return is to be filed and that is available in light of the condition of the debtor's books and records. In *In re Hudson Oil Co.*,[11] the bankruptcy court held that, although the trustee's liability is limited under section 1106(a)(6) of the Bankruptcy Code, the trustee is not excused from filing the corporate return for a year that ended just prior to the filing of the petition. The court also held that the IRS is not precluded from imposing late filing penalties and negligence

[7] *See also* P. Kanna, 75-1 USTC (CCH) 9450, 35 AFTR 2d 75-1482 (D.C. Ore. 1965).
[8] 882 F.2d 1507 (10th Cir. 1989).
[9] 1990 Bankr. LEXIS 709 (Bankr. N.D. Cal. 1990).
[10] 26 U.S.C. § 6601(a).
[11] 91 B.R. 932 (Bankr. D. Kan. 1988).

penalties against the corporation if the trustee files the return late or inaccurately. The return filed in this case was a corporate return, but the same responsibility should be expected of the trustee if the debtor is an individual.

I.R.C. section 1398 provides that a separate estate is created in a chapter 7 or chapter 11 filing. It is presumed that a separate estate is not created in a chapter 13 case. The bankruptcy court held that in a chapter 13 case, a separate estate is not created and the debtor is responsible for filing federal income tax returns.[12]

In *In re Shank*[13], the bankruptcy court examined the question as to whether the creditors' representative or the debtors are responsible for filing federal income tax returns and paying the taxes incurred in connection with the liquidation of assets sold as part of the debtors' confirmed plan of reorganization. The debtors' plan called for the disposition of estate property by two methods. The first method was for the estate to transfer property collateral to secured claim holders in full satisfaction of each recipient's allowed secured claim. The second method called for the sale of various assets, the proceeds of which would be distributed first to secured claim holders in satisfaction of their allowed secured claims, second to priority claimants, and the remainder to unsecured claim holders. The debtors used an undefined term, "asset pool," to describe the group of assets that were to be sold for the benefit of secured claim holders, priority claim holders, and unsecured claim holders. The debtors' plan also appointed a creditors' representative "to administer and liquidate the asset pool for the benefit of the debtors' creditors as provided for in the plan." The creditors' representative's specific duties included managing the assets in the asset pool, including, without limitation, collecting all rents, profits, and earnings arising from the same and paying all mortgages, taxes, and other expenses due and owing with respect to such assets from the rents, profits, and earnings of the asset pool; determining the listing price of the real property and negotiating the sale of the real properties and other interests in the asset pool; maintaining cash records; and making distributions to creditors provided for in the plan. The debtors were responsible for conveying the property to the parties provided for in the plan, including the creditors' representative, and assisting in the marketing and sale of the properties.

The bankruptcy court noted that "It is clear that upon confirmation of a plan of reorganization, property of the bankruptcy estate vests in the reorganized debtor, a new entity, and administration of the estate ceases."[14] Additionally, the court noted that the duty to pay federal income taxes is tied to the duty to make an income tax return. The Supreme Court noted in *Holywell*[15] by citing IRC section 6151 that "[w]hen a return of tax is required . . . the person required to make such return shall . . . pay such tax. . . ." Thus, the returns of an estate, trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code shall be made by the fiduciary thereof.

The bankruptcy court noted that in determining who is required to file tax returns and remit payment for taxes associated with the post-confirmation sale

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[12] *Elkins v. Commissioner*, 88-1 USTC (CCH) 9338 (Bankr. D.D.C. 1988).
[13] *In re Shank*, 240 B.R. 216 (Bankr. D. Mry. 1999).
[14] *U.S. v. Redmond*, 36 B.R. 932, 934 (D. Kan. 1984).
[15] *Holywell Corporation v. Smith*, 503 U.S. 47, 52, 112 S. Ct. 1021 (1992).

of the asset pool assets, the court's task is to determine the nature of the ownership of the assets in the asset pool. Thus, a determination that the assets are owned by the debtors would place the tax liability burden on the Shanks. However, the court noted that a determination that acknowledged ownership of the assets by a trust would shift the onus of filing returns and paying taxes to the creditors' representative as a trustee pursuant to I.R.C. section 6012(b)(4). By reference to the plan and the law of trusts, the court concluded that the assets in the asset pool vested in the debtors upon confirmation of their plan and that no trust was created upon such confirmation. Consequently, the bankruptcy court concluded that the creditors' representative "is neither obligated to file tax returns in connection with the liquidation of the Asset Pool assets, nor is he obligated to pay taxes arising there from."[16]

(c) Responsibility of Trustee

The trustee may be liable for a disbursement of funds that ignored a notice of levy.[17] The bankruptcy trustee for Central Micrographic Corporation's chapter 7 filing was approached by a real estate broker indicating that he had a prospective buyer of the debtor's assets. Trustee filed an application with the bankruptcy court to employ a business broker for the bankruptcy estate. The bankruptcy court's order provided that the broker would be paid a commission if his prospect was the successful buyer of the debtor's business.

A buyer was found, and the bankruptcy court ordered the sale of the property, which took place in June 1989. The agreement provided that payment of brokerage commissions was conditioned on approval of the bankruptcy court. The broker filed an application for allowance of a broker's fee as broker for the trustee, seeking a commission of $20,000. In July of that year, the bankruptcy court set a hearing date of August 3 on the broker's fee application, which the trustee received notice of before July 27. On July 27, the IRS served the trustee with a notice of levy for the broker's outstanding federal tax liabilities that exceeded the $20,000 fee. On August 10, 1989, the bankruptcy court approved the fee application, and on the next day the trustee wrote the broker a check for $20,000. The government sued the trustee for failing to honor the levy. The trustee argued that the broker had no right to a broker's commission until the bankruptcy court entered its order approving his application. The government contended that the broker had a property right in his commission at the time the notice of levy was served, even though he did not then have a present right to payment.

The district court held that the trustee is liable for failing to honor the levy against the broker's property. The court agreed with the government claim that at the time the notice of levy was served on the trustee, the broker had fully performed his brokerage services and the transaction had closed. The court ruled that under federal law the broker's earned but unpaid commission constituted property or rights to property subject to levy. The court cited *United States v.*

[16] Shank, *supra* note 13 at 221.

[17] *United States v. Ruff*, 179 B.R. 967 (M.D. Fla. 1995), *aff'd*, 99 F.3d 1559 (11th Cir. 1996).

Hubbell[18] and *Randall v. H. Nakashima & Co.*[19] in concluding that a right to proceeds of a contract is property. The district court thus held the trustee liable for the entire $20,000 under I.R.C. section 6332(d)(1).

§ 4.3 ACCOUNTING FOR THE BANKRUPTCY ESTATE

(a) Separate Entity

When bankruptcy proceedings intervene in the affairs of an individual, a separate taxable entity is created.[20] The new entity is the estate consisting of the property belonging to the debtor before bankruptcy, except exempt property. The trustee or debtor-in-possession is responsible for filing Form SS-4 (Application for Employer Identification Number) to obtain an identification number to use in filing tax returns. Rev. Proc. 89-37[21] allows the trustee to request bulk issuance of federal tax identification numbers. A sample letter requesting the identification numbers from the District Center of the Internal Revenue Service is shown in Exhibit 4.1. The IRS must be informed within the 30-day period specified in Rev. Proc. 89-37 of the assignment of an identification number to a bankruptcy estate. Exhibit 4.2 is a sample letter notifying the IRS of the assignment of an identification number.

EXHIBIT 4.1

Sample Letter to Request Block of Tax Identification Numbers

February —, 20X4

Internal Revenue Service
[District Center address]
____

____

Request for Bulk Issuance of Federal Tax Identification
Numbers Pursuant to Revenue Procedure 89-37

Pursuant to Revenue Procedure 89-37, 1989-1 CB 919, the undersigned hereby requests that you supply 50 employer identification numbers for assignment by the undersigned to Title 11 (bankruptcy) estates of individuals which constitute separate tax entities under section 1398 of the Internal Revenue Code. The undersigned hereby represents that he [she] is appointed by the United States Bankruptcy Court to act as trustee for at least 10 of such estates. The undersigned will inform you within the 30-day time period of Revenue Procedure 89-37 of the assignment of the identification numbers to bankruptcy estates.

Very truly yours,
[Signature]
Trustee

Source: Adapted from Kenneth J. Malek, "Basic Taxation," Proceedings, 7th Annual Reorganization and Bankruptcy Conference, Association of Insolvency and Restructuring Advisors (Medford, OR; Association of Insolvency and Restructuring Advisors, 1991), p. 20.

[18] 323 F.2d 197 (5th Cir. 1963).
[19] F.2d 270 (5th Cir. 1976).
[20] I.R.C. § 1398.
[21] 1989-1 C.B. 919.

Exhibit 4.2

Sample Letter Informing IRS of the Assignment of Tax Identification Numbers

March —, 20X4

Internal Revenue Service
[District Center address]
____

____

Notification of Assignment of Federal Tax Identification
Numbers Issued in Bulk Pursuant to Revenue Procedure 89-37

The undersigned hereby reports the information below and on the attached schedule pursuant to Revenue Procedure 89-37, 1989-1 CB 919:

(1) Name of the party submitting the request and the capacity in which the party is acting; Request submitted by [name of trustee], acting in capacity of Chapter 7 [and/or Chapter 11] trustee appointed by the United States Bankruptcy Court. There is not a co-fiduciary appointed and the undersigned submits this notification on behalf of [himself/herself] as trustee.

(2) All of the employer identification numbers assigned on the attached schedule are for Title 11 bankruptcy estates of individuals, and none is for a trust.

(3) The exact names of the bankruptcy estates are indicated on the attached schedule.

(4) There is no grantor or decedent involved in the creation of these estates, and all of such estates are created under section 541 of the United States Bankruptcy Code upon commencement of the respective bankruptcy cases.

(5) There is no named beneficiary involved in these estates; as trustee, I will liquidate the assets in the estates for the benefit of creditors.

(6) The name and date of establishment of each estate are indicated on the attached schedule.

(7) None of the entities named on the attached schedule has previously applied for or been assigned an EIN and none is subject to employment or excise taxes except with respect to possible payment of prepetition wage claims. As trustee, I will pay no postpetition wages. All employees were terminated on or before the commencement of the case.

The attached schedule and this letter are submitted in duplicate, as requested by Revenue Procedure 89-37.

Very truly yours,
[Signature]
Trustee

[on attached schedule]

(2) EIN assigned	(3) Exact name of bankruptcy estate (date of commencement of Title II proceeding)	(4) Date bankruptcy estate established
____________	________________________	________________________

Source: Adapted from Kenneth J. Malek, "Basic Taxation," Proceedings, 7th Annual Reorganization and Bankruptcy Conference, Association of Insolvency and Restructuring Advisors (Medford, OR, Association of Insolvency and Restructuring Advisors, 1991), pp. 21–22.

I.R.C. section 1398(f)(1) provides that the transfer (other than by sale or exchange) of property from the debtor to the estate is not a disposition for tax purposes and that the debtor will be treated as the estate would be treated with respect to such assets. Rev. Rul. 74-26[22] had previously held that a transfer of business in bankruptcy was a disposition.

[22] 1974-1 C.B. 7.

The IRS issued Rev. Rul. 90-25[23]to revoke Rev. Rul. 74-26. I.R.C. section 1398(f)(1) was effective for cases commencing after March 24, 1981.

After the petition has been filed, the bankruptcy estate can earn income and incur expenses. These transactions are administered by a trustee (or debtor-in-possession) for the benefit of the creditors. Concurrently, the individual debtor can also earn income, incur expenses, and acquire property; these do not become part of the bankruptcy estate. These separate taxable entities for federal income tax purposes occur in bankruptcy cases under chapters 7 and 11 of title 11 of the U.S. Code. No new taxable entity is created, however, under chapter 13 of the U.S. Code. When a bankruptcy case involving an individual is dismissed by the bankruptcy court, the estate is not deemed to have been a separate taxable entity. Because chapter 12 is patterned after chapter 13 and under chapter 13 no new entity is created, it might be concluded that under chapter 12 a new entity is also not created. However, section 1231 of the Bankruptcy Code provides the same state and local tax provisions for chapter 12 that apply for chapter 11; the taxable year of the individual terminates on the date of the order for relief and this termination marks the beginning of the tax period of the estate for state and local tax purposes. Thus, it appears that the drafters of chapter 12 were interested in having the tax provisions of chapter 12 follow chapter 11 and not chapter 13. Under this assumption, a new entity is created. However, until I.R.C. section 6012 is modified or the issue is resolved in the courts, there may be some uncertainty as to whether a new entity is created in chapter 12. The position of the Service is that a new estate is not created.

In a Private Letter Ruling,[24] the IRS stated that, in the case of a chapter 12 petition, a separate estate is not created. The failure of the IRS to allow the use of a separate estate for federal tax purposes for chapter 12 farmers (or the failure of Congress to pass a federal provision consistent with the state and local tax laws) has resulted in several farmers' electing to file chapter 11 instead of chapter 12. For example, in a chapter 12 case, if the trustee sells part of a farm at a gain, the tax responsibility remains with the individual. If the trustee has a plan confirmed before the end of the year in which the transfer occurred, the tax liability may not be provided for in the plan. Unsecured creditors may, in fact, receive from the sale of part of the farm the proceeds that should have gone to the IRS. The individual is then left responsible for the tax.

(b) Returns to Be Filed

In cases where the individual and the bankruptcy estate are separate entities, they are required to file separate returns. The estate files Form 1041 for the period beginning with the filing of the petition or for any subsequent year if gross income is equal to or greater than the sum of the exemption amount plus the basic standard deduction. For 2004, the filing requirement is gross income of at least $7,950. A bankruptcy judge held in *In re Jackie Ray Wills*[25] that the estate must file a return if the estate's gross income exceeds the dollar filing requir-

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[23] 1990-1 C.B. 10.

[24] Private Letter Ruling 8928012 (April 7, 1989).

[25] 46 B.R. 333 (Bankr. Md. 1985).

ment, even though there may not be any tax liability because of other tax attributes of the debtor under I.R.C. section 1398(g) or deduction allowed by I.R.C. section 1398(h). The judge also ruled that the tax liability determination was to be made under the "hurry up" provisions of section 505 of the Bankruptcy Code. The estate would not be eligible for income averaging. The individual files Form 1040, as usual, and reports all income earned during the year. This includes income earned before bankruptcy proceedings, but not any income earned by the estate. I.R.C. section 6012(b)(4) requires that the fiduciary of the estate file the return. This would be the trustee, if appointed; otherwise, the debtor-in-possession must file the estate's return.

The IRS issued letters to chapters 7 and 11 debtors indicating that two Form 1041s and two Form 1040s should be filed. The taxpayer and spouse will each be required to file Form 1041 and attach a separate Form 1040 with the tax calculated based on the rates for a married person filing separate returns. The income needs to be divided between the husband and wife. In community property states all income earned by both spouses should be divided into half. Fifty percent of the income should be placed on the husband's Form 1040 that is attached to his 1041, and the other 50 percent should be placed on the wife's Form 1040 that is attached to her 1041. At one time the IRS was in the process of preparing a new form to be used in bankruptcy cases by the estate; however, it has been approximately 20 years since the IRS indicated a new form was being developed.

The position taken by the IRS in this letter is consistent with the decision in *In re Knobel*,[26] but which the IRS objected to in this case. The bankruptcy court held that in the case of a jointly filed chapter 7 bankruptcy petition "each estate in a jointly filed case, unless the court orders substantive consolidation, is entitled to a personal exemption and a standard deduction, as an individual deemed to be married filing separately, in calculating their respective taxable income." The IRS argued that only one estate and one taxable entity is created upon the filing of a joint petition under section 302 of the Bankruptcy Code. The bankruptcy court rejected the IRS position noting that the filing of a joint petition, even though only one case is filed, only one case number is assigned, only one employer identification number is assigned, and only one trustee is appointed, is for administrative purposes and does not result in de facto substantive consolidation. Thus, by issuing this letter the IRS is unofficially reversing its position and accepting the conclusion reached by the bankruptcy court in *Knobel.*

The court noted that in the case of community property, the fact that into each estate falls the debtor's and his or her spouse's interest in community makes segregation of property less than practical, and which may in the average case warrant substantive consolidation. However, substantive consolidation according to the bankruptcy court does not occur until the courts have issued such an order. In *In re Ageton*,[27] the Bankruptcy Appeals Panel concluded that the statute means what it says and "until and unless consolidation is ordered, there remains two estates subject to administration in a joint case." As a result of *Ageton,* the Chief Judge for the Central District of California issued General

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[26] 167 B.R. 436 (Bankr. W.D. Texas 1994).
[27] 14 B.R. 833 (Bankr. 9th Cir. 1981).

Order 97-04, indicating that all chapter 7 petitions of spouses filed under one case number are to be deemed substantively consolidated under section 302(b) of the Bankruptcy Code unless the court orders otherwise. Thus, in the central district of California, the debtor should file only one Form 1041 for both the husband and wife. The tax liability will be calculated on a single Form 1040 for each joint petition based on the tax rates for a married person filing separate returns. Form 1040 will be attached to Form 1041 as described in the text. Only one tax identification number will be needed for each joint petition. It appears that this order is effective for all petitions filed after August 4, 1997.

On Form 1041, the trustee for the estate will check the bankruptcy box as shown in Exhibit 4.3, then file Form 1040, U.S. Individual Income Tax Return, figuring the tax for the bankruptcy estate the same way as for a married person filing separately. The tax liability from Form 1040 should be transferred to Form 1041 and the debtor-in-possession or the trustee should sign Form 1041.[28]

The trustee or debtor-in-possession must withhold income and social security taxes and file the related employment tax returns for wages paid that are administrative expenses, priority claims, or unsecured claims. These withheld taxes, according to orders generally issued by the U.S. trustees, in chapter 11 cases are to be segregated in a separate account until the federal deposits are made. In chapter 7 and chapter 11 cases where the U.S. trustee may not demand segregation, it is still advisable to place these withholdings in a separate account or make immediate deposits, to avoid any potential liability for these taxes under I.R.C. section 6672.

Social security taxes are to be withheld at the current rate. Federal income taxes are to be based on the withholding tax tables published in *IRS, Circular E, Employer's Tax Guide.* The trustee or debtor-in-possession may also use the alternative 20 percent rate method as provided in Treas. Reg. section 31-3402(g)-1. In determining the amount of social security taxes and the federal and state unemployment taxes to be withheld, it would appear that the wages paid by the individual debtor prior to the filing of the petition should be included in the base. On Form W-2, issued to employees at year-end, the trustee or debtor-in-possession would include wages paid prior to the filing of the petition with those paid after the petition is filed. Thus, the employee will receive only one Form W-2 and excess amounts of social security taxes will not have been withheld.

Csontos[29] suggested that this is the policy to follow in chapter 7 cases (he did not address the issue in chapter 11 cases). However, it could be argued that, because the separate estate is created, there are two separate taxable entities. There would therefore be a final Form W-2 filed by the debtor, including the period prior to the filing of the bankruptcy petition, and another W-2 for the period subsequent to the filing of the petition. The problem with this argument is that I.R.C. section 1398 creates a separate estate only for federal income tax purposes and only for individuals in a chapter 7 or chapter 11 case; it does not address the issue of employment taxes.

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[28] IRS Announcement 81-96, May 7, 1981.

[29] Csontos, The IRS and the Trustee: Tax Return Filing Issues (mimeographed) (Sept. 28, 1988), at 3.

Exhibit 4.3

Estate Tax Return

Form **1041** Department of the Treasury - Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2003** OMB No. 1545-0092

For calendar year 2003 or fiscal year beginning , 2003, and ending , 20

A Type of entity (see instr.):
- ☐ Decedent's estate
- ☐ Simple trust
- ☐ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☐ Grantor type trust
- ☐ Bankruptcy estate-Ch. 7
- ☐ Bankruptcy estate-Ch. 11
- ☐ Pooled income fund

Name of estate or trust (If a grantor type trust, see page 12 of the instructions.)

Name and title of fiduciary

Number, street, and room or suite no. (If a P.O. box, see page 12 of the instructions.)

City or town, state, and ZIP code

C Employer identification number

D Date entity created

E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 13 of the instructions):
- ☐ Described in section 4947(a)(1)
- ☐ Not a private foundation
- ☐ Described in section 4947(a)(2)

B Number of Schedules K-1 attached (see instructions) ▶

F Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Change in fiduciary's name ☐ Change in fiduciary's address

G Pooled mortgage account (see page 13 of the instructions): ☐ Bought ☐ Sold Date

Section	Line	Description	Line	Amount
Income	1	Interest income	1	
	2a	Total ordinary dividends	2a	
	b	Qualified dividends allocable to: (1) Beneficiaries .... (2) Estate or trust		
	3	Business income or (loss) (attach Schedule C or C-EZ (Form 1040))	3	
	4	Capital gain or (loss) (attach Schedule D (Form 1041))	4	
	5	Rents, royalties, partnerships, other estates and trusts, etc. (attach Schedule E (Form 1040))	5	
	6	Farm income or (loss) (attach Schedule F (Form 1040))	6	
	7	Ordinary gain or (loss) (attach Form 4797)	7	
	8	Other income. List type and amount	8	
	9	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	9	
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes	11	
	12	Fiduciary fees	12	
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees	14	
	15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	**Total.** Add lines 10 through 15b	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶	17	
	18	Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041))	18	
	19	Estate tax deduction (including certain generation-skipping taxes) (attach computation)	19	
	20	Exemption	20	
	21	**Total deductions.** Add lines 18 through 20 ▶	21	
Tax and Payments	22	Taxable income. Subtract line 21 from line 17. If a loss, see page 18 of the instructions	22	
	23	**Total tax** (from Schedule G, line 7)	23	
	24	**Payments: a** 2003 estimated tax payments and amount applied from 2002 return	24a	
	b	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	24b	
	c	Subtract line 24b from line 24a	24c	
	d	Tax paid with extension of time to file: ☐ Form 2758 ☐ Form 8736 ☐ Form 8800	24d	
	e	Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐	24e	
		Other payments: f Form 2439 .... ; g Form 4136 .... ; Total ▶	24h	
	25	**Total payments.** Add lines 24c through 24e, and 24h ▶	25	
	26	Estimated tax penalty (see page 19 of the instructions)	26	
	27	**Tax due.** If line 25 is smaller than the total of lines 23 and 26, enter amount owed	27	
	28	**Overpayment.** If line 25 is larger than the total of lines 23 and 26, enter amount overpaid	28	
	29	Amount of line 28 to be: **a Credited to 2004 estimated tax ▶** ; **b Refunded ▶**	29	

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of fiduciary or officer representing fiduciary | Date | EIN of fiduciary if a financial institution

May the IRS discuss this return with the preparer shown below (see instr.)? ☐ Yes ☐ No

Paid Preparer's Use Only Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2003)

Exhibit 4.3 *(continued)*

Estate Tax Return

Form 1041 (2003) Page 2

Schedule A — Charitable Deduction. Do not complete for a simple trust or a pooled income fund.

1	Amounts paid or permanently set aside for charitable purposes from gross income (see page 20)	1	
2	Tax-exempt income allocable to charitable contributions (see page 20 of the instructions)	2	
3	Subtract line 2 from line 1	3	
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes (see page 20 of the instructions)	6	
7	**Charitable deduction.** Subtract line 6 from line 5. Enter here and on page 1, line 13	7	

Schedule B — Income Distribution Deduction

1	Adjusted total income (see page 20 of the instructions)	1	
2	Adjusted tax-exempt interest	2	
3	Total net gain from Schedule D (Form 1041), line 16a, column (1) (see page 20 of the instructions)	3	
4	Enter amount from Schedule A, line 4 (reduced by any allocable section 1202 exclusion)	4	
5	Capital gains for the tax year included on Schedule A, line 1 (see page 21 of the instructions)	5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6	
7	**Distributable net income (DNI).** Combine lines 1 through 6. If zero or less, enter -0-	7	
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law — 8		
9	Income required to be distributed currently	9	
10	Other amounts paid, credited, or otherwise required to be distributed	10	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 21 of the instructions	11	
12	Enter the amount of tax-exempt income included on line 11	12	
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	

Schedule G — Tax Computation (see page 21 of the instructions)

1	**Tax:** a Tax on taxable income (see page 21 of the instructions) — 1a		
	b Tax on lump-sum distributions (attach Form 4972) — 1b		
	c Alternative minimum tax (from Schedule I, line 56) — 1c		
	d **Total.** Add lines 1a through 1c ▶	1d	
2a	Foreign tax credit (attach Form 1116) — 2a		
b	Other nonbusiness credits (attach schedule) — 2b		
c	General business credit. Enter here and check which forms are attached: ☐ Form 3800 ☐ Forms (specify) ▶ — 2c		
d	Credit for prior year minimum tax (attach Form 8801) — 2d		
3	**Total credits.** Add lines 2a through 2d ▶	3	
4	Subtract line 3 from line 1d. If zero or less, enter -0-	4	
5	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611	5	
6	Household employment taxes. Attach Schedule H (Form 1040)	6	
7	**Total tax.** Add lines 4 through 6. Enter here and on page 1, line 23 ▶	7	

Other Information

		Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends ▶ $		
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		
3	At any time during calendar year 2003, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? See page 23 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country ▶		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See page 24 of the instructions		
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see page 24 for required attachment		
6	If this is an estate or a complex trust making the section 663(b) election, check here (see page 24) ▶ ☐		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see page 24) ▶ ☐		
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here ▶ ☐		
9	Are any present or future trust beneficiaries skip persons? See page 24 of the instructions		

Form **1041** (2003)

Exhibit 4.3 *(continued)*

Estate Tax Return

Form 1041 (2003) Page 3

Schedule I — Alternative Minimum Tax (see pages 24 through 30 of the instructions)

Part I—Estate's or Trust's Share of Alternative Minimum Taxable Income

1	Adjusted total income or (loss) (from page 1, line 17)	1	
2	Interest	2	
3	Taxes	3	
4	Miscellaneous itemized deductions (from page 1, line 15b)	4	
5	Refund of taxes	5	( )
6	Depletion (difference between regular tax and AMT)	6	
7	Net operating loss deduction. Enter as a positive amount	7	
8	Interest from specified private activity bonds exempt from the regular tax	8	
9	Qualified small business stock (see page 25 of the instructions)	9	
10	Exercise of incentive stock options (excess of AMT income over regular tax income)	10	
11	Other estates and trusts (amount from Schedule K-1 (Form 1041), line 9)	11	
12	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	12	
13	Disposition of property (difference between AMT and regular tax gain or loss)	13	
14	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	14	
15	Passive activities (difference between AMT and regular tax income or loss)	15	
16	Loss limitations (difference between AMT and regular tax income or loss)	16	
17	Circulation costs (difference between regular tax and AMT)	17	
18	Long-term contracts (difference between AMT and regular tax income)	18	
19	Mining costs (difference between regular tax and AMT)	19	
20	Research and experimental costs (difference between regular tax and AMT)	20	
21	Income from certain installment sales before January 1, 1987	21	( )
22	Intangible drilling costs preference	22	
23	Other adjustments, including income-based related adjustments	23	
24	Alternative tax net operating loss deduction (See the instructions for the limitation that applies.)	24	( )
25	Adjusted alternative minimum taxable income. Combine lines 1 through 24	25	
	Note: *Complete Part II on page 4 before going to line 26.*		
26	Income distribution deduction from Part II, line 44 — 26		
27	Estate tax deduction (from page 1, line 19) — 27		
28	Add lines 26 and 27	28	
29	Estate's or trust's share of alternative minimum taxable income. Subtract line 28 from line 25	29	

If line 29 is:

- $22,500 or less, stop here and enter -0- on Schedule G, line 1c. The estate or trust is not liable for the alternative minimum tax.
- Over $22,500, but less than $165,000, go to line 45.
- $165,000 or more, enter the amount from line 29 on line 51 and go to line 52.

Form **1041** (2003)

Exhibit 4.3 *(continued)*

Estate Tax Return

Form 1041 (2003) Page **4**

Part II—Income Distribution Deduction on a Minimum Tax Basis

30	Adjusted alternative minimum taxable income (see page 28 of the instructions)	**30**		
31	Adjusted tax-exempt interest (other than amounts included on line 8)	**31**		
32	Total net gain from Schedule D (Form 1041), line 16a, column (1). If a loss, enter -0-	**32**		
33	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes (from Schedule A, line 4)	**33**		
34	Capital gains paid or permanently set aside for charitable purposes from gross income (see page 28 of the instructions)	**34**		
35	Capital gains computed on a minimum tax basis included on line 25	**35**	(	)
36	Capital losses computed on a minimum tax basis included on line 25. Enter as a positive amount	**36**		
37	Distributable net alternative minimum taxable income (DNAMTI). Combine lines 30 through 36. If zero or less, enter -0-	**37**		
38	Income required to be distributed currently (from Schedule B, line 9)	**38**		
39	Other amounts paid, credited, or otherwise required to be distributed (from Schedule B, line 10)	**39**		
40	Total distributions. Add lines 38 and 39	**40**		
41	Tax-exempt income included on line 40 (other than amounts included on line 8)	**41**		
42	Tentative income distribution deduction on a minimum tax basis. Subtract line 41 from line 40	**42**		
43	Tentative income distribution deduction on a minimum tax basis. Subtract line 31 from line 37. If zero or less, enter -0-	**43**		
44	**Income distribution deduction on a minimum tax basis.** Enter the smaller of line 42 or line 43. Enter here and on line 26	**44**		

Part III—Alternative Minimum Tax

45	Exemption amount				**45**	$22,500	00
46	Enter the amount from line 29	**46**					
47	Phase-out of exemption amount	**47**	$75,000	00			
48	Subtract line 47 from line 46. If zero or less, enter -0-	**48**					
49	Multiply line 48 by 25% (.25)				**49**		
50	Subtract line 49 from line 45. If zero or less, enter -0-				**50**		
51	Subtract line 50 from line 46				**51**		
52	Go to Part IV of Schedule I to figure line 52 if the estate or trust has qualified dividends or has a gain on lines 15a and 16a of column (2) of Schedule D (Form 1041) (as refigured for the AMT, if necessary). Otherwise, if line 51 is— • $175,000 or less, multiply line 51 by 26% (.26). • Over $175,000, multiply line 51 by 28% (.28) and subtract $3,500 from the result				**52**		
53	Alternative minimum foreign tax credit (see page 29 of the instructions)				**53**		
54	Tentative minimum tax. Subtract line 53 from line 52				**54**		
55	Enter the tax from Schedule G, line 1a (minus any foreign tax credit from Schedule G, line 2a)				**55**		
56	**Alternative minimum tax.** Subtract line 55 from line 54. If zero or less, enter -0-. Enter here and on Schedule G, line 1c				**56**		

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Exhibit 4.3 *(continued)*

Estate Tax Return

Form 1041 (2003) Page **5**

Part IV—Line 52 Computation Using Maximum Capital Gains Rates

Caution: *If you did not complete Part V of Schedule D (Form 1041), see page 29 of the instructions before completing this part.*

Line	Description	Inner box	Outer box
57	Enter the amount from line 51		57
58	Enter the amount from Schedule D (Form 1041), line 23, or line 13 of the Schedule D Tax Worksheet, whichever applies (as refigured for the AMT, if necessary)	58	
59	Enter the amount from Schedule D (Form 1041), line 15d, column (2) (as refigured for the AMT, if necessary)	59	
60	If you did not complete a Schedule D Tax Worksheet for the regular tax or the AMT, enter the amount from line 58. Otherwise, add lines 58 and 59 and enter the **smaller** of that result or the amount from line 10 of the Schedule D Tax Worksheet (as refigured for the AMT, if necessary)	60	
61	Enter the **smaller** of line 57 or line 60		61
62	Subtract line 61 from line 57		62
63	If line 62 is $175,000 or less, multiply line 62 by 26% (.26). Otherwise, multiply line 62 by 28% (.28) and subtract $3,500 from the result ▶		63
64	Enter the amount from Schedule D (Form 1041), line 27, or line 19 of the Schedule D Tax Worksheet, whichever applies (as figured for the regular tax)	64	
65	Enter the **smaller** of line 57 or line 58	65	
66	Enter the **smaller** of line 64 or line 65	66	
67	If you did not complete a Schedule D Tax Worksheet for the regular tax or the AMT, enter the amount from Schedule D (Form 1041), line 40 (or if that line is blank, the amount from Schedule D (Form 1041), line 28). Otherwise, enter the amount from line 32 of the Schedule D Tax Worksheet on page 37 of the instructions (or if that line is blank, the amount from line 20 of that worksheet). Refigure all amounts for the AMT, if necessary (see page 29 of the instructions)	67	
68	Enter the **smaller** of line 66 or line 67	68	
	If line 66 is zero, go to line 76. Otherwise, go to line 69.		
69	Multiply line 68 by 5% (.05) ▶		69
70	Subtract line 68 from line 66. If zero or less, enter -0- and go to line 76	70	
71	Enter your qualified 5-year gain, if any, from Schedule D (Form 1041), line 15c, column (2) (as refigured for the AMT, if necessary) 71		
72	Enter the **smaller** of line 70 or line 71	72	
73	Multiply line 72 by 8% (.08) ▶		73
74	Subtract line 72 from line 70	74	
75	Multiply line 74 by 10% (.10) ▶		75
76	Subtract line 68 from line 67	76	
77	Subtract line 66 from line 65	77	
78	Enter the **smaller** of line 76 or line 77	78	
79	Multiply line 78 by 15% (.15) ▶		79
80	Subtract line 78 from line 77	80	
81	Multiply line 80 by 20% (.20) ▶		81
	If line 59 is zero or blank, skip lines 82 and 83 and go to line 84. Otherwise, go to line 82.		
82	Subtract line 65 from line 61	82	
83	Multiply line 82 by 25% (.25) ▶		83
84	Add lines 63, 69, 73, 75, 79, 81, and 83		84
85	If line 57 is $175,000 or less, multiply line 57 by 26% (.26). Otherwise, multiply line 57 by 28% (.28) and subtract $3,500 from the result		85
86	Enter the **smaller** of line 84 or line 85 here and on line 52		86

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In a sense, there is the creation of a new legal entity, which might suggest that two IRS Form W-2s need to be filed. However, this application would apply to corporations as well as to individuals. Filing of two Form W-2s has not been the general practice.

If an employee fails to receive an IRS Form W-2 for any wages paid by the debtor-in-possession or the trustee for the period prior to or the period following the filing of the petition, IRS Form 4852, indicating the estimated amount of taxes withheld, should be completed and attached to the individual's tax return. Following these procedures will allow the employee to receive credit for taxes withheld even though the withholdings may not have been reported to the IRS.

A problem does arise as to how to handle the quarterly tax returns that should be filed by the employer (e.g., Form 941). As discussed in § 11.2(d), the employer's taxes and withholdings on wages paid prior to the date the petition is filed are considered prepetition taxes. It may be advisable to file two quarterly returns—one for wages paid that were earned prior to the filing of the petition, and the other for wages earned after the petition is filed.

Even though a separate estate may be created when an individual becomes involved in bankruptcy proceedings, this will not cause a Subchapter S corporation in which the individual is a shareholder to lose its S status. The Tax Reform Act of 1986 added I.R.C. section 1361(c)(3), which specifically allows the estate of a bankrupt to continue on as an S corporation shareholder.

(c) Attribute Carryover to Estate

The estate succeeds to (inherits) and takes into account the following income tax attributes of the debtor in a chapter 7 or 11 case:[30]

1. Net operating loss carryovers under I.R.C. section 172;
2. Capital loss carryovers under I.R.C. section 1212;
3. Tax benefit treatment for any amount subject to the I.R.C. section 111 tax benefit rule (relating to bad debts, prior taxes, and delinquency amounts);
4. Credit carryovers and all other items that, except for the commencement of the case, the debtor would be required to take into account with respect to any credit;
5. Charitable contribution carryover under I.R.C. section 170(d)(1);
6. The debtor's basis, holding period, and character of any asset acquired (other than by sale or exchange) from the debtor;
7. The debtor's method of accounting;
8. Other tax attributes of the debtor to the extent provided by Treasury Regulations. Regulations have added three items to the list of attributed carryover:
   - **(a)** Unused passive activity losses and credits
   - **(b)** Unused losses from at-risk activities
   - **(c)** Exclusion from income the gain on sale of residence.

[30] I.R.C. § 1398(g).

For example, the Treasury Regulations could allow the estate the benefit of I.R.C. section 1341 if the estate repays income the debtor received under claim of right.[31] However, until added by Treasury Regulations, income tax computational benefits under section 1341 are not tax attributes that are transferred to the bankruptcy estate.[32]

The attributes are determined as of the first day of the debtor's taxable year in which the case commences. For example, if a bankruptcy petition is filed on May 5, 20X2, and the individual does not file a short tax return, the tax attributes are carried over as of January 1, 20X2 (calendar year taxpayer). Also, it would appear that the estate would be able to claim depreciation expense for the period of January 1 to May 5 even though the estate's taxable year does not begin until May 5. Any income earned by the individual subsequent to the beginning of the tax year, but prior to the filing of the petition, could not be offset against a net operating loss carryover. An election (see §§ 4.4(a)(i) and (ii)), however, can be made by the individual to file a short tax return and have the estate pay any tax due. It would appear that, if the debtor made this election, the tax attributes would carry over as of the date the bankruptcy petition was filed. Because of the election to file a short tax return, the date the petition was filed becomes the first day of the debtor's taxable year in which the case commences.

(i) Passive Activity Losses

Treas. Reg. sections 1.1398-1 and -2 provide that the bankruptcy estate succeeds to the unused passive activity losses and credits under I.R.C. section 469 and to the unused losses from at-risk activities under I.R.C. section 465 of an individual debtor in a case under chapter 7 or chapter 11.

Under I.R.C. section 469, which was added to the code by the Tax Reform Act of 1986, passive activity losses and credits are disallowed and treated as deductions or credits allocable to the same activity in the next taxable year. Passive activity losses and credits are not among the attributes enumerated in I.R.C. sections 1398(g) and (i).

I.R.C. section 465, added to the code by the Tax Reform Act of 1976, limits a taxpayer's deductible loss from an activity to the taxpayer's amount "at risk" (within the meaning of I.R.C. section 465(b)) in that activity. If a loss is not allowed under I.R.C. section 465, it is treated as a deduction allocable to the same activity in the next taxable year. Losses that are not allowed under I.R.C. section 465 are not among the attributes enumerated in I.R.C. sections 1398(g) and (i).

The IRS noted that the transfer of unused passive activity losses and credits from the debtor to the estate is consistent with one of the primary purposes of I.R.C. section 1398, that is, to treat the bankruptcy estate as the tax successor of the debtor. The unused passive activity losses and credits to which the estate succeeds are determined as of the first day of the debtor's taxable year in which the bankruptcy case commences, in accordance with the current provision of I.R.C. section 1398(g): the estate succeeds to and takes into account the specified

[31] S. Rep. No. 1035, 96th Cong., 2d Sess. 26 (1980).
[32] *Langdon M. Cooper, et al. v. United States*, No. 3:97CV502-V (W.D. N.C. May 17, 2000).

attributes determined as of the first day of the taxable year in which the bankruptcy case commences.

Treas. Reg. sections 1.1398-1 and -2 does not just provide for the carryover of the tax attribute of unused passive activity losses and credits and the unused losses from at-risk activities under I.R.C. section 465. It also provides that a transfer of an interest in a passive activity to the debtor as exempt under section 522 of the Bankruptcy Code or as abandoned to the debtor under section 554(a) of that title is a nontaxable transfer. The impact of this section is discussed in §§ 2.8(a) and (d).

The regulations provide that, in the case of a transfer from the estate to the debtor (other than by sale or exchange), such as a transfer due to abandonment of an interest in a passive activity or former passive activity before the termination of the estate, the debtor succeeds to and takes into account the estate's unused passive activity loss and credit from the activity (determined as of the first day of the estate's taxable year in which the transfer occurs). In the case of a transfer of assets, such as in an abandonment, that constitute part of an activity, the debtor succeeds to and takes into account the allocable portion of unused passive activity loss and credit as determined by the estate.

The regulations provide that, upon the termination of the estate, the debtor shall succeed to and take into account the estate's unused passive activity loss and credit as provided for in I.R.C. section 1398(i).

Treas. Reg. section 1.1398-2 provides that the bankruptcy estate succeeds to any unused losses of an individual debtor that are not allowed under I.R.C. section 465 in a case under chapter 7 or chapter 11. The rules in the regulations for the transfer of unused losses from the debtor to the estate and from the estate to the debtor generally parallel the rules in the regulations for passive activity losses and credits under I.R.C. section 469, including the nontaxability of a transfer to the debtor of exempt property or the abandonment of the property to the debtor.

The provisions of Treas. Reg. sections 1.1398-1 and -2 were effective for bankruptcy cases commencing on or after November 9, 1992. For cases commenced before November 9, 1992, the regulations apply only if a joint election is made by the debtor and the estate. In a chapter 7 case, the election is valid only with the written consent of the bankruptcy trustee. In chapter 11 cases, the election is valid only if it is incorporated (1) into a bankruptcy plan that is confirmed by the bankruptcy court or (2) into an order of the court. Special provisions on how to make the election were contained in the regulation.

In Private Letter Ruling 9304008, the IRS ruled that the debtor succeeds to any passive activity losses of the estate that are allocable to an asset that is abandoned as of the first day of the bankruptcy estate's taxable year in which the abandonment occurs.[33] It is assumed that the passive activity losses referred to are those that were incurred after the property was transferred to the estate. However, the debtor would also succeed to passive activity losses that are carried over to the estate under the election provisions of Treas. Reg. section 1.1398-2.

[33] *Id.*

Treas. Reg. section 1.1398-1 contains special rules for any year in which an amended return cannot be filed because it is for a closed year for passive activity losses and credits; Treas. Reg. section 1.1398-2 contains special rules for unused at-risk losses under I.R.C. section 465.

(ii) Gain on Sale of Residence

Treas. Reg. section 1.1398-3 allows an estate to succeed to the exclusion from income of a gain on the sale of a residence. Taxpayer Relief Bill of 1997 modified IRC section 121 to provide for a $500,000 ($250,000 nonjoint return) exclusion of gain realized on the sale or exchange of a principal residence. On October 6, 2000, the IRS issued proposed regulations[34] that would add the exclusion of the gain on the sale of residence to the list of tax attributes under I.R.C. section 1398 that an individual's bankruptcy estate may succeed to and take into account when determining the estate's taxable income in a chapter 7 or 11 bankruptcy case. The regulations became effective for sales and exchanges on or after December 24, 2002.[35] This ruling was a departure from the Service's prior position that was generally supported by the courts where the exclusion was not carried over to the estate under prior law.

Prior to the issuance of Treas. Reg. 1.1398-3, the Service indicated that it will no longer challenge the use of this exclusion by the trustee. In a chief counsel notice, the Service advised district counsel attorneys of a change in its litigating position and will no longer challenge the use of the section 121 exclusion on the gain from a sale of a personal residence by the estate.[36]

Prior to the change in the tax law expanding the allowance of the exclusion of income on the sale of a residence, the Service took the position that the estate did not succeed to this attribute with the support of the courts. For example in *In re Mehr*,[37] the bankruptcy court held that the bankruptcy trustee is not entitled to make the election allowed under I.R.C. section 121 (the "section 121 election"), which allows for a one-time exclusion of a gain on the sale of a residence up to $125,000 for a married couple filing joint returns. The bankruptcy court noted that the language of the statute requires the election to be made by "the taxpayer," the taxpayer must have reached the age of 55, and the taxpayer must have used the property as a principal residence for more than 3 of the past 5 years. The court concluded that a bankruptcy estate cannot possess the requirements set forth by the statute.

(iii) Unlisted Attributes

Generally courts have held that the debtor's estate could not succeed to passive activity losses of the debtor in chapter 11 because they are not specifically listed or included under Treasury Regulations.[38] This decision preceded the decision by the Treasury to add these losses to the list of attribute carryovers. The court

[34] 65 FR 6936 Reg-105235-99 (October 10, 2000).
[35] 67 FF 78358, TD 9030 (December 24, 2002).
[36] N(35)000-162,LTRServe, Aug. 23, 1999, p. 6663.
[37] 93-1 USTC (CCH) 50,091 (Bankr. D.C. N.J., 1993).
[38] See *In re Antonelli, Jr.*, 92-2 USTC (CCH) 50,619, 140 B.R. 5 (Bankr. D. Md. 1992).

rejected the argument that passive activity losses can be included as tax attributes because they are closely related to net operating loss and capital loss carryovers, holding that passive losses are unique in nature and separately defined. This ruling may be viewed as contrary to *Traylor v. Commissioner,* in which the Tax Court held that related-party debt rules could be applied despite the absence of specific inclusion under Treasury Regulations.[39] *In Di Stasio v. United States*,[40] the court of claims held that a debtor's "claim of right," a tax attribute specifically listed in Bankruptcy Code section 346(i), did not belong to the estate for purposes of federal taxation because I.R.C. section 1398(g) does not expressly enumerate that attribute.

In *In re Rueter*,[41] the district court reversed the bankruptcy court's ruling that the tax attributes belong to the bankruptcy estate. The court held that, unless the Secretary of the Treasury has enacted regulations adding particular tax attributes to the list set forth in I.R.C. section 1398(g), the courts are not empowered to read such additional attributes into the statute. In *Rueter,* the court held that the debtor's passive activity losses were not converted into net operating losses.

In a Private Letter Ruling,[42] the IRS held that the estate does not succeed a debtor's passive activity losses on the filing of a bankruptcy petition. The IRS's position was that, because passive activity losses are not among the tax attributes listed in I.R.C. section 1398(g), the passive activity losses do not carry over to the estate. In this letter, the IRS appears to be taking the position that a tax attribute that is not listed will not carry over to the estate.

This Private Letter Ruling also held that if the bankruptcy estate disposes of its entire interest in a passive activity acquired from the debtor to an unrelated party, any passive activity losses of the debtor that are allocable to such passive activity are to be treated as losses that are not from passive activity pursuant to I.R.C. section 469(g).

Based on these cases and the private letter ruling, generally any attribute that is not on the list provided for in section 1398 or by subsequent regulations will not apply. However, with the change in section 121, courts held that the estate could use the section 121 exclusion prior to the Service issuing regulations approving the assumption of the exclusion by the estate. For example, In *In re Luciano Popa,*[43] the bankruptcy court held that a bankruptcy trustee is entitled to use the current version of I.R.C. section 121 to exclude gain on the debtor's residence, although other courts have held that the prior version did not apply to bankruptcy estates.

Luciano Popa filed a chapter 7 petition and received a discharge in 1996. His residence was listed on the schedules with a fair market value of $150,000 and was subject to a $109,700 mortgage. Popa listed unsecured claims of $19,300.

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[39] 59 T.C.M. (CCH) 93 (1990).
[40] 90-2 USTC (CCH) 50,577 (Cl. Ct. 1990).
[41] 158 B.R. 163 (N.D. Cal. 1993).
[42] 9304008 (Jan. 29, 1993).
[43] 218 B.R. 420, 81 A.F.T.R.2d (RIA) 1282 (Bankr. N.D. Ill. 1998), *aff'd Popa v. Peterson*, 238 B.R. 395 (N.D. Ill. 1999).

Popa also claimed a $7,500 homestead exemption. Including the cost of sale, it was estimated that Popa's equity was only $8,600. Popa filed a motion to have the chapter 7 trustee abandon the estate's interest in the residence because there was no equity in the property after giving his wife the $7,500 homestead exemption he claimed she was entitled to and after paying the estimated $12,000 in capital gains tax on the sale of the residence.

The trustee objected to Popa's motion, arguing that Popa's wife was not entitled to a homestead exemption and requested a determination of tax liability, claiming that the estate would be entitled to exclude gain on a sale of the residence under section 121. The Service objected to the trustee's request, arguing that there was no case or controversy because the property had not been sold. On the merits, the Service claimed that the estate was not entitled to the excluded gain on sale under section 121.

The bankruptcy court rejected the Service's "case or controversy" argument, explaining that the section 121 issue was relevant to Popa's motion to compel the trustee to abandon the residence. The court noted that the tax consequences of the sale must be considered to determine the validity of Popa's assertion that there is no equity in the property.

While the court found no cases addressing whether a bankruptcy estate succeeds to the debtor's eligibility for the section 121 exclusion as the statute now reads, it noted that two cases held that a bankruptcy trustee could not use the onetime exclusion for individuals over 55 (the former statute).[44]

The bankruptcy court relied on section 1398(g)(6), which provides that the estate succeeds to the debtor's holding period and to the character of the asset, and on sections 1398(c)(1) and 1398(f)(1), which provide that an estate is taxed like an individual and that the estate shall be treated as the debtor would be with respect to assets transferred from the debtor to the estate.

The court was able to reconcile its conclusion with the results of *In re Mehr* and *In re Barden*. The court pointed out that the former section 121 imposed an age requirement on the taxpayer that the estate itself could not satisfy. The court noted that the new statute permits a taxpayer to use the exclusion repeatedly, whereas the over-age-55 exclusion was a onetime benefit intended to help promote savings for retirement. Additionally, the court found that both the Mehr and the Barden courts did not discuss section 1398(f)(1) in any meaningful way, and the court was not persuaded by their analysis of section 1398(g)(6).

Finally, the bankruptcy court found this result supported by policy considerations. The court described a hypothetical situation in which a taxpayer with unsecured debts files for bankruptcy, discharges the debts, compels the trustee to abandon the house because the tax liability reduces or eliminates his equity, sells the house without any liability to the discharged creditors, uses the section 121 exclusion, and pockets the proceeds tax-free. The court noted that this result would neither mirror nonbankruptcy entitlements nor make tax considerations as neutral as possible.

[44] *In re Mehr*, 153 B.R. 430 (Bankr. D.N.J. 1993), and *In re Barden*, 205 B.R. 451 (E.D.N.Y. 1996), *aff'd*, 105 F.3d 821 (2d Cir. 1997).

Over a half dozen cases have held that a trustee can use modified section 121 to allow for the estate a $500,000 ($250,000 single taxpayer) exclusion from income of the gain on the sale of a principal residence.[45] Seeing how the courts were ruling on the estate being able to assume this attribute, the Service first indicated that it would no longer challenge the use of this exclusion by the trustee and then subsequently issued the regulation referred to earlier.[46]

Section 541 of the Bankruptcy Code provides that, on the commencement of a bankruptcy case, an estate is created that comprises essentially all of the property of the debtor. That property includes:

1. All equitable interests of the debtor in property as of the date the case commences;
2. All interests of the debtor and the debtor's spouse in community property;[47]
3. Any interest in property that may be recovered by the trustee or debtor-in-possession;
4. Inheritance to which the debtor may be entitled within 180 days after the petition is filed;
5. Rents, proceeds, product, offspring, or profits from property of the estate;
6. Any interest in property that the estate acquires after the petition is filed.

Property that is exempt under section 522 of the Bankruptcy Code is not part of the estate. However, until it is determined that the property is in fact exempt, it is considered property of the estate.

The taxpayer is not entitled to a claim for refund after a bankruptcy case is closed and the trustee did not file for the refund.[48] Weiner filed for bankruptcy in October 1985, and did not include his claim for a tax refund for 1980 in his list of assets. He was adjudicated bankrupt in May 1986, and the case was closed on September 1, 1986.

In looking at the issue as to whether Weiner was entitled to a claim for refund, the court reasoned that Weiner's failure to disclose the claim caused the bankruptcy trustee to be unaware of the asset. Thus, the claim was neither abandoned nor administered, and as a result it remained the property of the estate. The court found that the claim did not revert to Weiner, and he could not maintain a claim to the refund because the bankrupt estate was the real party in interest. (See § 4.4(b).)

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[45] Other cases that have followed the Popa ruling include *In re Godwin*, 230 B.R. 341 (Bankr. S.D. Ohio 1999); *In re Kerr*, 1999 U.S. Dist. LEXIS 2310, 99-1 USTC Par. 50,310, 83 A.F.T.R.2d (RIA) 1490 (W.D. Wash 1999); *In re Williams*, 235 B.R. 795 (Bankr. D. Md. 1999); *In re Bradley*, 222 B.R. 313 (Bankr. M.D. Tenn. 1998), *aff'd* 245 B.R. 533 (M.D. Tenn, 1999); *In re Sevy*, 1999 U.S. Dist. LEXIS 3087 (W.D. Wash. 1999); *In re Slye*, 1999; Bankr. LEXIS 937 (Bankr. D. Md. 1999). It appears that only one case has held otherwise: *In re Winch*, 226 B.R. 591 (Bankr. S.D. Ohio 1998).

[46] N(35)000-162, LTRServ, Aug. 23, 1999, p. 6663.

[47] Exempt property may be removed from the estate on petition by the spouse.

[48] *Weiner v. United States*, 88-2 USTC (CCH) 9466, 15 Cl. Ct. 43 (1988).

(iv) Accounting Period

Because the estate adopts the debtor's method of accounting, it might be assumed that the estate would adopt the debtor's tax year and date. However, the Internal Revenue Code makes no provision for this. A separate entity has been created. Treas. Reg. section 1.441-1(b)(3) states:

> A new taxpayer in his first return may adopt any taxable year which meets the requirements of I.R.C. section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including extensions) for the filing of the return for such taxable year.

Because the bankruptcy estate is taxed as an individual, I.R.C. section 645, which requires trusts to use a calendar year, is not applicable to bankruptcy estates.

A fiscal year is established by filing a tax return within the fifteenth day of the fourth month following the end of the month that is selected as the end of the taxable year.[49] If the trustee or debtor-in-possession fails to establish a fiscal year on a timely basis, the estate must file the return on a calendar-year basis. A fiscal year is established only by filing a tax return on a timely basis. Temporary Treas. Reg. section 1.441-1T(b)(2) indicates that the election of a fiscal year cannot be made by filing an application for extension of time to file the return. The trustee or debtor-in-possession should evaluate the extent to which the payment of taxes could be delayed or reduced by the selection of the fiscal year. For example, if property with a low value is transferred in settlement of debt and results in a taxable gain, the taxpayer may want to extend the end of the fiscal year to allow for the inclusion of losses on the sale of other property.

In a Private Letter Ruling,[50] the IRS has granted a firm an extension to file an application to change its accounting period. The firm explained that it didn't know when the application was due, and that the due date arrived at a busy time (when the firm was emerging from bankruptcy). The IRS granted the firm an extension because good cause had been shown.

Berenson and Honecker suggested that, because other tax attributes are specifically listed and the year-end of the debtor was not listed, one could justly conclude that such omission indicates that it was not intended that the estate necessarily adopt the individual's year-end.[51] To further support this position, it should be noted that the original House version of I.R.C. section 1398(d)(1) provided that the first taxable year of the estate shall be the same as the taxable year of the debtor, but the provision was not included in the final version.[52] Also, section 346(b)(3) of the Bankruptcy Code dealing with state and local taxes provides that the estate "use the same accounting method as the debtor."

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[49] I.R.C. § 441(e).

[50] Private Letter Ruling 9522046 (Mar. 7, 1995).

[51] Berenson & Honecker, The Bankruptcy Tax Act of 1980 (Part III), 12 *Tax Adviser* 277, 278 (1981).

[52] Bankruptcy Tax Act and Minor Tax Bills: Hearings on H.R. 5043 and Other Bills Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong., 1st Sess., § 3(a)(1), 26 (1979).

Legislative history indicates that this omission was intentional by stating that section 346(b)(3) requires the use of the accounting method, but not necessarily the accounting period.[53] Thus, an estate that begins with the date the petition is filed may adopt any taxable year-end without prior approval of the commissioner, provided the initial period is not more than 12 months.

If the year selected by the trustee or debtor-in-possession for the estate is less than 12 months, income for the short year does not have to be annualized as provided for in I.R.C. section 443(a). The estate will also be able to deduct the full exemption and the standard deduction for a married person filing a separate return.

(v) Net Operating Loss

I.R.C. Section 1398 provides that the estate succeeds to the tax attributes of the debtor in a chapter 7 or chapter 11 case. Since section 1398 provides that the debtor succeeds to the tax attributes of the debtor, it might be concluded that the estate does not succeed to the net operating loss carryovers that are allocated to the nonbankrupt spouse that has filed separate returns or that is legally separated or divorced from the debtor.

Treas. Reg. section 1.172-7(d) provides that a husband and wife who are filing separate returns for the current year, but who filed joint returns for any or all of the intervening years, must allocate their joint net operating losses to each spouse if they claim a net operating loss (NOL) deduction during the current year for which separate returns are filed. Treas. Reg. section 1.172-7(d)(2) indicates that the net operating loss of each spouse for the tax year for which a joint return was made is the portion of the joint net operating loss that is attributable to the gross income and deductions of the spouse, with gross income and deductions of that spouse taken into account to the same extent that they are taken into account in computing the joint net operating loss.

Example 1 of Treas. Reg. section 1.172-7(g) indicates that Harry and Wanda filed joint returns for 20X1 and 20X2 and had a net operating loss in 20X1 of $1,000 and a net operating loss of $2,000 in 20X2. If these losses are carried to a year in which Harry and Wanda file separate returns, or Harry and Wanda file separate returns in any intervening year, the losses must be allocated to each spouse. Example 1 provides that if in 20Xl Harry's deductions exceeded his gross income by $700 and Wanda's deductions exceeded her gross income by $300, Harry would be entitled to $700 of the net operating loss and Wanda would be entitled to $300 of the net operating loss. In 20X2, if Harry's gross income exceeded his deductions by $1,500 and Wanda's deductions exceeded her income by $3,500, all of the net operating loss of $2,000 would be allocated to Wanda.

The Ninth Circuit, affirming appellate panel's decision, held that a couple's prepetition election under IRC section 172 to waive their NOL carrybacks was avoidable by the bankruptcy trustee as a fraudulent transfer under 11 U.S.C. section 548.[54]

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[53] S. Rep. No. 989, 95th Cong., 2d Sess. 45 (1978).
[54] *In re Feiler*, 218 F. 3d 948 (9th Cir. 2000).

The Ninth Circuit noted that there are four requirements for fraudulent transfer under section 548(a)(1)(B):

1. The election was exercised on or within one year of the Feilers' bankruptcy filing.
2. It was in return for future tax benefits with a value that is less than, and not reasonably equivalent to, the value of the tax refund that was relinquished when the election was exercised.
3. It was while the Feilers were insolvent.
4. The election was a transfer of an interest of the Feilers in property.

The Ninth Circuit explained that the only item in dispute was whether section 548 can ever be used to avoid an election under IRC section 172(b)(3), and, if so, whether the election satisfies the fourth requirement of section 548. The Ninth Circuit concluded that a bankruptcy trustee's avoidance powers under section 548 take precedence over the otherwise irrevocable nature of a taxpayer's election under IRC section 172 and that the Feilers' election to waive the NOL carrybacks and thereby forego the tax refunds constituted a "transfer" to the government of an "interest of the debtor in property" under 11 section 548 of the Bankruptcy Code.

In states that are community property states, it would appear that all of the income and deductions from property acquired and income earned after marriage would be allocated 50 percent to the husband and 50 percent to the wife.

While the NOL of a spouse may not be transferred to the estate under the provisions of I.R.C. section 1398, it might be argued that the NOL carryforward is property, especially under community property states, of the estate and thus would be transferred to the estate. Section 541 provides that all community property of a debtor's spouse will be included in the debtor's estate. Thus, if the NOL carryforward is considered community property, it will be transferred to the estate.

Two factors must be considered in determining if the NOL carryforward is community property.

- Is the NOL carryforward property?
- If the NOL carryforward is considered property, is it community property?

The Supreme Court held in *Segal v. Rochelle*[55] that an estate in bankruptcy is entitled to use the loss carrybacks of the debtor. Thus the estate can apply current losses to prior profits and be entitled to the tax refund. However, in *Segal* the Court did not rule on the issue of whether prior losses can be applied to current profits. The Court noted that "[w]ithout ruling in any way on a question not before us, it is enough to say that a carryover into post-bankruptcy years can be distinguished conceptually as well as practically." The court further stated that "The bankrupts in this case had both prior net

[55] 383 U.S. 375 (1966).

income and a net loss when their petitions were filed and apparently would have deserved an immediate refund had their tax year terminated on that date; by contrast, the supposed loss-carryover would still need to be matched in some future year by earnings, earnings that might never eventuate at all. In *In re Luster*,[56] the Seventh Circuit held in a preBankruptcy Code case, that a NOL carryforward is not property. The court noted that Luster was unable to transfer his net operating loss to creditors and that his creditors could not use his loss carryforwards to satisfy a judgment lien.

The next question deals with even if the NOL carryforward is considered property, is it community property? When a separate return is filed, the NOL carryforwards are not community property, but are an attribute that is available for exclusive use of the taxpayer to whom the losses are allocated. If all of the NOLs of one taxpayer are used by the filing of a separate return, that taxpayer is not entitled to the loss of the other taxpayer as long as separate returns are filed. In *In re Luster*,[57] the Seventh Circuit held that Federal rather than state law governs transferability of federal tax benefits. It would appear that under Federal law the NOL carryforward would not be community property and thus would not be transferred to the estate. Under I.R.C. section 1398 only the tax attributes of the debtor are transferred to the estate.

The Second Circuit held that a net operating loss carryforward attributable to a corporate debtor belongs to the debtor under section 541 of the Bankruptcy Code and does not, under the law of consolidated returns, belong to its parent company.[58] *Prudential Lines* and other cases based on the Bankruptcy Code have held that the NOL carryforward is property.[59] If this holding was applied to the individual, the NOL carryforward in community property states of the nonfiling spouse would belong to the estate.

The bankruptcy court held the IRS was precluded from challenging the debtor's application of a NOL carryback, because the statute of limitations for assessment had run for the year in which the loss was reported.[60] The taxpayer followed the incorrect order in carrying back a NOL. The taxpayer claimed losses on his 1984-86 returns based on his ownership interest in a limited partnership that was subject to the Tax Equity and Fiscal Responsibility Act (TEFRA) rules. The IRS made adjustments to partnership items that were subject to the TEFRA rules for those three years, which were allowed by the Tax Court.

When the Service adjusted the taxpayer's taxable income for the years in question, it is also reapplied the loss carryback in the proper order, resulting in a tax liability plus interest for 1986. The tax claim was assessed in October 1994. The taxpayer filed a chapter 7 case in 1995 and argued that the statute of limitations barred the IRS from making any adjustment relating to the carryback of the

[56] 981 F.2d 277 (7th Cir. 1992).

[57] *Id*.

[58] *In re Prudential Lines*, 928 F.2d 565 (2d Cir. 1991); *see In re Russell*, 927 F.2nd 413 (8th Cir. 1991).

[59] *See also In re Phar-Mor, Inc*., 152 B.R. 924 (Bankr. N.D. Ohio 1993) (carryforward held property of estate and protected by both automatic stay and injunction against sale of stock causing reduction of NOL); *In re Beery*, 116 Bankr. 808, 810 (D. Kan. 1990).

[60] *In re Madden*, 1996 Bankr. LEXIS 439, 96-1 USTC (CCH) 50,263 (Bankr. D.N.J. 1996).

NOL. The bankruptcy court held that the NOL carryback was not an affected item under I.R.C. section 6231(a)(5), because it was not affected by any partnership item.

(d) Estate's Income

Gross income of the estate includes all income received or accrued by the estate and the gross income of the debtor to which the estate is entitled under title 11.[61] Excluded from the estate is any income received or accrued by the debtor before the commencement of the case. For example, salary that was earned by a cash-basis debtor prior to bankruptcy but not received until after the commencement of the case would be income of the estate, provided the receivable from back wages is considered property of the estate under the Bankruptcy Code.

In looking at the income of the estate, it is important to distinguish between the property of the estate and the gross income of the estate. Under the previous bankruptcy law, the definition of property was narrowly defined. For example, the Supreme Court decision of *Lines v. Frederick*[62] excluded earned income from the property of the bankruptcy's estate. The Bankruptcy Code has defined property in a much broader way. Section 541(a)(6) of the Bankruptcy Code defines *property* as: "Proceeds, product, offspring, rents, and profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case."

In the case of an accrual-basis taxpayer, gross income, which is accrued before commencement of the proceedings and included in the income of the individual debtor, would become property of the estate as of the date the petition was filed and, as such, the estate would be entitled to the proceeds from wages earned prior to the commencement of the case.

(i) Partnerships and S Corporations

When an individual files a bankruptcy petition, section 541 of the Bankruptcy Code provides that the property of the debtor (unless excluded as exempt property under section 522 of the Bankruptcy Code), including interest in a partnership or stock in an S corporation, is considered property of the estate. In the case of a partnership, any income or loss from the partnership is reported on the return for the estate for all tax years ending after the petition is filed. For example, if an individual who owns an interest in Partnership Y files a chapter 11 petition on December 15, 20X2, all of the income, gains, and losses reported on Form K-1 from Partnership Y for the entire year are reflected on the tax return filed by the estate. This is true even though most of the events creating the gains and losses for Partnership Y occurred prior to the filing of the petition. The K-1 should reflect the new identification number of the estate and not the social security number of the individual.

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[61] I.R.C. § 1398(e)(1).

[62] 400 U.S. 18 (1970).

In a Private Letter Ruling,[63] the IRS held that all items of income, gain, loss, deduction, or credit of a partnership for the year in which the individual partner files a bankruptcy petition are allocable to the bankruptcy estate. The IRS noted that the transfer of the debtor's interest in the partnership to the bankruptcy estate does not close the taxable year of the partnership with respect to the debtor under I.R.C. section 706(c)(2)(A)(i), and the transfer is not treated as a change in a partner's interest in the partnership under I.R.C. section 706(d).

It has been argued that income or loss from a partnership must be reported by the debtor and the estate according to their varying interests during the taxable year. This allocation may be made based on the time periods when the partnership interest was held by the debtor and the estate, or, as some would suggest, the amount attributable to the debtor might be determined by closing the books the day before bankruptcy was filed. Advocates of the varying-interests approach argue that it does not necessarily conflict with I.R.C. section 1398(f)(1); even though the transfer is not characterized as a "disposition," it does not automatically follow that the debtor and estate had no variation of interest. Although the nondisposition status would prevent the application of I.R.C. section 706(c)(2) to the transfer, it would not preclude the effect of I.R.C. section 706(d), which is activated by a mere "change" in partner interest. For example, in *Guaranty Trust Co. of New York v. Commissioner*,[64] the Supreme Court held (prior to the Internal Revenue Code of 1954, when there was *not* a special rule for decedents) that the decedent's final Form 1040 was required to include partnership income for the partnership's full tax year ending within the decedent's final year plus his pro rata share of partnership profits through the date of his death. I.R.C. section 706(c), Treas. Reg. section 1.706-1(c)(3), and legislative history[65] indicate need for a statutory amendment specifically addressing decedents in order to avoid the bunching-of-income result under *Guaranty Trust.* See McKee, Nelson, and Whitmire[66] for a discussion recommending restricted scope for I.R.C. section 706(d) but not opposing the interpretation that the section can be applied to the commencement year of a chapter 7 or chapter 11 bankruptcy case against a partner who is an individual.

In the case of an S corporation, the gains and losses are prorated.

(e) Estate's Deductions, Credits, and Employment Taxes

Prior to the Bankruptcy Tax Act, considerable confusion existed as to the type of deductions allowed by the bankrupt estate. I.R.C. section 1398(e)(3) was passed in an attempt to resolve these problems by providing that an amount would be allowed as a deduction or credit if the debtor had paid or incurred the amount in connection with the debtor's trade or business conducted prior to commencement of the proceedings and if the debtor would have been entitled to these deductions or credits. Also included in the amount paid would be wages to

[63] Private Letter Ruling 9304008 (Jan. 29, 1993).
[64] 303 U.S. 493 (1938).
[65] H. R. Rep. No. 1337, 83d Cong., 2d Sess. A225-226 (1954).
[66] Federal Taxation of Partnerships and Partners, 11.03 (1990).

allow for the deduction of employment taxes. Expenses not paid by the estate but paid by the individual, a debtor subsequent to the filing of the petition, would be allowed as a deduction of the individual. There is no provision for the apportionment of deductions and credits between the debtor and the estate as exists with respect to the taxability of the debtor's income. Generally the estate can take all deductions available to the individual including the standard deduction for a single person (zero bracket amount for taxable years ending before January 1, 1987).

Section 541 of the Bankruptcy Code provides that all community property of a debtor's spouse that is under the sole, equal, or joint management and control of the debtor will be included in the debtor's estate. In *Smith v. Commissioner*,[67] the Tax Court concluded that in a year in which the wife was not in bankruptcy, the wife was not entitled to one half of the deductions otherwise available to the husband's bankruptcy estate due to the fact that the wife had a community property interest in the assets which gave rise to the deductions. Thus, it would appear that any income or expenses that is attributable to the community property that is in the bankruptcy estate will be an income or expense item of the estate and not that of the nonbankrupt spouse.

How should the estate handle payments that are made by the estate to the individual? Based on the above discussion, it might be assumed that the payments would be either wages or consulting type of income. As the result of a Private Letter Ruling,[68] there is now considerable uncertainty as to how to report these payments. The actual wording of I.R.C. section 1398(e)(3)(B) is as follows:

> *Rule for making determinations with respect to deductions, credits, and employment taxes.* Except as otherwise provided in this section, the determination of whether or not any amount paid or incurred by the estate—
>
> A.is allowable as a deduction or credit under this chapter, or
>
> B.is wages for purposes of subtitle C,
>
> shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses, and in the activities, the debtor was engaged in before the commencement of the case.

In the Private Letter Ruling, the IRS looked at the issue of whether withdrawals by a debtor-in-possession are wages. In this situation, a farmer and his wife filed a chapter 11 petition. The farmer had been engaged to manage the farm for the bankruptcy estate as a debtor-in-possession, as provided for in the Bankruptcy Code. The bankruptcy estate treated the farmer as an employee of the estate and characterized amounts withdrawn from the estate for personal expenses as the payment of manager's salary. The farmer asked whether, for federal employment tax purposes, a debtor-in-possession should be treated as an employee of the bankruptcy estate.

The IRS concluded that "[a]ccordingly, for purposes of determining whether the amounts withdrawn by you constitute wages for federal employment tax purposes, section 1398(e)(3)(B) of the Code requires such amounts to be treated as though they had been paid by you and as though you were still engaged in

[67] T.C. Memo 1995-406, 70 T.C.M. (CCH) 483 (1995).

[68] Private Letter Ruling 8728056 (April 15, 1987).

the business of operating your farm. Thus, we conclude that these amounts are not considered as wages paid you as an employee of the bankruptcy estate."

It might be assumed from this Private Letter Ruling that the IRS is stating that the amounts paid are not wages but distributions that are taxable to the individual and deductible by the estate, requiring Form 1099 to be filed. A careful review of the text would, however, also suggest that, because the payments cannot be considered wages for employment tax purposes, they could not be considered a deduction because the same modification ("amount . . . paid . . . as if the debtor were still engaged in the trades and businesses . . . ," I.R.C. section 1398(e)(3)(B)) that applies to the wages also applies to the deduction.

Legislative history suggests that the purpose of the modification was not to consider the issue of how wages paid to the owner are handled, but to deal with the problem of how to deduct expenses and handle wages if the trustee does not operate the debtor's trade or business. A Senate Report on the subject stated:

> Under present law, it is not clear whether certain expenses or debts paid by the trustee are deductible if the trustee does not actually operate the debtor's trade or business (and if such expenses are not incurred in a new trade or business of the estate). To alleviate this problem, the bill provides that an amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would be deductible or creditable by the debtor had the debtor remained in the same trades, businesses, or activities after the case commenced as before and had the debtor paid or incurred such amount. The same test is applied to determine whether amounts paid by the estate constitute wages for purposes of Federal employment taxes (I.R.C. section 1398(e)(4)).[69]

In many cases, it would be to the advantage of the debtor to claim that amounts paid are not income (wages or Form 1099 income items) but distributions of the assets of the estate. Often, the individual has no deductions because all of his or her property was transferred to the estate and the individual must pay taxes on the income received from the estate. At the same time, the estate has the net operating losses of the individual that were acquired when the petition was filed, and does not need the wage deduction. The Private Letter Ruling[70] might indicate that the amounts paid to the individual by the estate are withdrawals or distributions and not income. However, it is suggested here that the IRS has misapplied I.R.C. section 1398(e)(3)(B) and that it will not be extended to apply to deductions as well.

(i) Accrued Expenses

One problem arises in accounting for the expenses paid by the estate. For example, if an accrual-basis taxpayer incurs and deducts an expenditure prior to filing of the petition and subsequently the estate makes the necessary payment, it would appear that the estate would not be able to make the deduction, but the taxpayer would be entitled to the deduction because the amount should have been deducted on the accrual basis prior to the commencement of the proceedings. Thus, wages that have been accrued by a debtor and that were sub-

[69] S. Rep., *supra* note 31, at 30.
[70] *Supra* note 68.

sequently paid by a trustee in a chapter 7 or chapter 11 proceeding would not be deductible by the estate. These deductions are prepetition obligations, and they do not constitute administrative expense as defined under section 503 of the Bankruptcy Code. All administrative expenses are those that generally arise after the commencement of a case. However, suppose that the expenses that were deductible for accounting purposes were not liabilities according to the definition of a liability found in the Bankruptcy Code. Once an item becomes a liability, which, let's assume, is subsequent to the filing of the petition, then it would appear that the item would be considered an administrative expense and there is a possibility that it could be deducted by the estate at the time it is filed. Keep in mind, however, that there is some uncertainty about the prospect of being able to deduct this item twice.[71]

The Senate Finance Committee Report indicated that the new Internal Revenue Code did not intend to allow an item to be deducted twice. For example, the Committee Report stated:

> If any item of deduction or credit of the debtor is treated under new code section 1398(e)(3) as a deduction or credit of the bankruptcy estate, that item is not allowable to the debtor as a deduction or credit on his or her return or a joint return with the debtor's spouse. (New code section 1398(e)(3).) This rule is intended to insure that no particular item of deduction or credit can be allowable to both the debtor and the estate.[72]

(ii) Administrative Expenses

Considerable conflict existed under prior law as to how to handle administrative expenses. The Bankruptcy Tax Act contains several provisions that clarified some aspects of how to account for administrative expenses and left unanswered other questions.

I.R.C. section 1398(h)(1) now provides that any administrative expense allowed under section 503 of the Bankruptcy Code and any fees or charges assessed under chapter 123 of title 28 of the U.S. Code (court fee and costs) are deductible expenses of the estate. These expenses are allowed even though some of them may not be considered trade or business expenses. Administrative expenses are, however, subject to disallowance under other provisions of the I.R.C., such as section 263 (capital expenditures), 265 (expenses relating to tax-exempt interest), or 275 (certain taxes). It would appear that the administrative expenses would also be subject to the disallowance of personal interest expense under I.R.C. section 163.

The administrative expenses would include the actual, necessary costs of preserving the estate, including wages, salaries, and commissions for services rendered after the commencement of the case. Also, any tax, including fines or penalties, is allowed unless it is related to a tax granted preference under section 507(a)(7) of the Bankruptcy Code. Compensation awarded professional persons, including accountants and attorneys for postpetition services, is an

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[71] *See* comments of Kenneth N. Klee, A Conference on the Bankruptcy Tax Act of 1980, 39 *Inst. on Fed. Tax'n* (NYU), § 57.09[8] (1981).

[72] S. REP., *supra* note 31, at 31.

administrative expense.[73] The Tax Court concluded that legal expenses, including bankruptcy legal expenses, were deductible because the litigated claims related to the debts of a corporation for which the debtor was a shareholder and officer.[74] The failure of the corporation forced the debtor to file a bankruptcy petition.

A major addition to the new law is a provision that allows any amount of administrative, liquidation, and reorganization expenses not used in the current year to be carried back 3 years and carried forward 7 years. The amount that is carried to any other taxable year is stacked after the net operating losses for that particular year. The unused administrative expenses can only be carried back or carried over to the taxable years of the estate. I.R.C. section 1398(h)(2)(D) also provides that expenses that are deductible solely because of the provision of I.R.C. section 1398(h)(1) are allowable only to the estate. Thus, the administrative expenses cannot be carried forward to the debtor once the bankruptcy proceedings are concluded.

Note that the restriction on carryback or carryover of administrative expenses to the estate applies only to those deductions that are allowed solely by reason of I.R.C. section 1398(h)(1). Thus, it would appear that an expense (even though it is an administrative expense in a bankruptcy case) that would normally be classified as an operating cost could be carried forward to the debtor, once the estate is terminated, as an item in the net operating loss carryover. Included would be salary, wages, and other costs necessary to operate a business in a chapter 11 case. However, costs such as attorneys' fees for a wage earner, court filing costs, and other types of administrative costs that are not normally deductible, except for the fact that they are administrative expenses, are allowed only by the estate and would be classified as administrative expenses. In *W. Ainsworth v Commissioner*,[75] the Tax Court refused to allow the individual to deduct legal fees the individual paid related to the taxpayer's personal bankruptcy. The court noted that there was insufficient evidence of a proximate relationship between the taxpayer's business activities and the personal bankruptcy.

The administrative expense carryforward is considered after the net operating loss. First, a separate net operating loss computation would be made under I.R.C. section 172(b)(2), and then the administrative expense deduction would be carried forward after the net operating loss has been used. The Finance Committee of the Senate observed: "These carryovers are 'stacked' after the net operating loss deduction (allowed by section 172 of the Code) for the particular year."[76]

There exists some uncertainty as to how the administrative expenses are classified on the Form 1040 that is filed with the Form 1041 (estate return). Items that are normally deducted, such as expenses allowed on Schedule C, E, or F, should be handled in the normal manner. Administrative expenses that would not be allowed except for the fact that a title 11 petition was filed could be con-

[73] 11 U.S.C. § 503(b)(4).
[74] *Scofield v. Commissioner*, T.C. Memo 1997-547, 74 T.C.M. (CCH) 1536.
[75] 54 T.C.M. (CCH) 122 (1987).
[76] S. Rep., *supra* note 31, at 29.

sidered deductions for adjusted gross income or deductions from adjusted gross income in the form of itemized deductions. With the 2 percent limitation on miscellaneous itemized deductions added by the Tax Reform Act of 1986, the amount of administrative expenses allowed could be reduced significantly if these costs are listed as itemized deductions. Administrative costs are not included in the list of exceptions to the 2 percent limitation. Because I.R.C. section 1398(h) provides that these costs are deductible and, if not used, can be carried back 3 years or carried forward 7 years, it would appear that they should be considered deductions for adjusted gross income.

In *In re Miller*[77] the chapter 7 trustee filed a motion for determination of the bankruptcy estate's tax liability to creditor IRS, asserting fees and expenses from administration of the estate were fully deductible on the estate's final tax return under I.R.C. section 67(e). IRS argued expenses were subject to the two-percent floor on miscellaneous itemized deductions under I.R.C. section 67(a). The bankruptcy court held that a bankruptcy estate is one of the "types of 'estates' for which section 67(e) was designed and that the bankruptcy estate created at the inception of this bankruptcy case may indeed utilize its provisions." The bankruptcy court held that payment of expenses incurred in the administration of the bankruptcy estate was properly taken "above-the-line" by this bankruptcy estate in computing the adjusted gross income on its tax return. The bankruptcy court rejected the Service arguments that the expenses can only be taken as a miscellaneous itemized deduction because of the provisions in Publication 908[78] noting that "a litigant may not properly cite its own composition as persuasive, much less binding, authority and, even if it were produced by a more independent source, Publication 908 fails to offer the slightest bit of analysis or reasoning for its conclusion that administrative expenses can only be treated as an itemized miscellaneous deduction and it wholly fails to even mention the possible application of I.R.C. section 67(e) and its effect on the deductibility of administrative expense payments."[79]

In *In re Sturgill*,[80] the bankruptcy court held that expenses deducted by the estate on Schedule C were not business expenses and thus were to be deducted as expenses subject to the 2 percent limitation. However, as noted by the court in *Miller*, the trustee did not suggest that they were not subject to the 2 percent limitation because of the provisions in section 67(e).

These administrative expenses could be listed as a negative value in the other income category on the front of Form 1040.

(f) Net Operating Loss Carryback

I.R.C. section 1398(j)(2)(A) provides that, if the estate incurs a net operating loss (apart from the loss passing to the estate from the debtor, described in 4.3(c)), the estate can carry back its net operating loss to taxable years of the individual

[77] 252 B.R. 110 (Bankr. E.D. Tex 2000).
[78] Internal Revenue Service, U.S. Dept. of Treasury, Pub. No. 908, Bankruptcy Tax Guide 4 (1996).
[79] *Supra* note 77.
[80] 217 B.R. 291 (Bankr. D. Oregon 1998).

debtor prior to the years in which the bankruptcy proceeding commenced, as well as to previous taxable years of the estate. The new law also allows the bankruptcy estate to carry back excess credits, such as an investment tax credit, to the years prior to the commencement of the case. The individual is prohibited from carrying back either the net operating losses or other credits (see § 4.4(e)).

(g) Change in Accounting Period

I.R.C. section 1398(j)(1) allows an estate to change its accounting period (taxable year) once without obtaining approval of the IRS, as is normally required under I.R.C. section 442. This rule allows the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate and then to submit a return for a "short year" for an expedited determination of tax liability as permitted under section 505 of the Bankruptcy Code.[81] Income from the short year due to the estate's being terminated prior to year-end need not be annualized. Thus, the full personal exemption and standard deduction are allowed (I.R.C. section 443(a)(2) and (c)).

(h) Tax Liability of the Estate

Administrative expenses are paid out of the property of the estate. Section 522 of the Bankruptcy Code provides that administrative expenses are not to be paid out of exempt property. Thus, the debtor should not be personally liable for any tax that is classified as an administrative expense. (See § 11.2(b) for a discussion of the taxes that are considered administrative expenses.) Any tax liability that is created by the estate on the disposition of property or on the transfer of property in settlement of the debt is an administrative expense of the estate under Bankruptcy Code section 503(b)(1)(B)(i). The tax obligation is not a debt of the debtor, but of the estate.

In *In re Seslowsky*,[82] the bankruptcy court indicated that the trustee, by not abandoning and keeping the interest of the partnership in the estate, effectively prevented the United States from pursuing the debtors for the unpaid income tax liability generated by the sale of the partnership's assets.

The estate has the responsibility for paying, after the petition is filed, any tax that becomes due that would be classified as an administrative expense. This tax liability is an obligation of the estate and not of the individual. For example, in *In re Kochell*[83] the Seventh Circuit held that when the debtor filed the petition the estate succeeded to the individual retirement account (IRA) benefits. Any penalty tax under I.R.C. section 408(f)(1) due to the early withdrawal of funds from the IRA by the trustee is a liability of the estate. The court further ruled that "Kochell personally was out of the picture."

In *Larontonda v. Commissioner*,[84] the Tax Court held that an involuntary withdrawal from a Keogh account to satisfy a federal tax lien was not subject to the

[81] S. Rep., *supra* note 31, at 30.
[82] 182 B.R. 612 (Bankr. S.D. Fla. 1995).
[83] 804 F.2d 84 (7th Cir. 1986).
[84] 89 T.C. 287 (1987).

I.R.C. section 72(m)(5) penalty for premature withdrawal. However, the Office of Chief Counsel has announced nonacquiescence to this decision with no appeal (AOD No. CC-1988-010). The IRS in taking this position cited *In re Kochell*.[85] This case involved an IRA distribution in bankruptcy where the court held that the statute makes no exceptions from the penalty except in cases of disability. The IRS also stated that the individual "benefitted to the same extent as if he had withdrawn the money himself in order to pay off creditors."

The tax liability is not a tax attribute that reverts to the debtor upon the termination of the estate. Although the debt is not technically discharged, it appears that it will not become a liability of the individual debtor. Thus, in cases where all of the debtor's property is secured with a low basis, such as farm property, and the property is transferred in settlement of the debt, the individual debtor may avoid having to pay the tax on the transfer by filing a chapter 7 or 11 petition before the transfer takes place. The tax obligation is that of the estate, but the estate has no assets with which to pay the tax. If a bankruptcy petition is not filed or if the property is transferred prior to the filing of the petition, the tax liability is a debt of the individual that cannot be discharged.

Often, in situations where it is desirable to transfer the tax liability to the estate, it is better to file a chapter 11 petition and adopt a chapter 11 plan of liquidation. After all assets are sold, if there are not enough assets to pay the income taxes, it may be advisable to convert the chapter 11 petition to a chapter 7. In chapter 11 cases, I.R.C. section 1129(a)(9) provides that in order for a plan to be confirmed, the plan must provide for the payment of all administrative expenses. Thus, it may be necessary for the debtor to convert the case to chapter 7 in order to avoid this problem. If the judge, as has happened in some chapter 7 cases, allows the trustee to abandon the undersecured property to the debtor, it appears the tax liability would be that of the individual and not the estate. Section 554 of the Bankruptcy Code gives the trustee the right after notice and a hearing to abandon any property of the estate that is burdensome or that is of inconsequential value and benefit to the estate. See § 4.3(j).

A question may arise as to the status of the administrative expenses that were paid before the property was transferred. In *In re Isis Foods*,[86] the district court held that administrative expenses may be paid prior to the effective date of the plan. In this case, the trustee objected to the payment of postpetition obligations incurred by a debtor-in-possession that he replaced. In fact, the debt was paid out of funds from which a secured lender had been expressly granted a super lien.

In *In re Seslowsky*,[87] the bankruptcy court would not allow the IRS claim, resulting from the sale of a partnership where the sale proceeds were less than the tax on the gain, to be subordinated to that of other administrative expenses. The court noted that if there was any questionable conduct, it was on the part of the Trustee. The proper course of action by the Trustee might have been to seek

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85 *Supra* note 83.
86 27 B.R. 156 (W.D. Mo. 1982).
87 182 B.R. 612 (Bankr. S.D. Fla. 1995).

judicial approval for abandonment of the partnership interest, under section 554 of the Bankruptcy Code.[88] (See § 11.2(b)).

(i) Distributions from the Estate

Section 1398(f)(2) provides that in the termination of the estate, a transfer (other than by sale or exchange) of an asset of the estate from the estate to the debtor is not treated as a disposition for tax purposes. Proceeds from the sale of a claim were not considered a distribution from the bankruptcy estate.[89] The taxpayer's receipt of $5.75 million for the sale of her claims against her former husband's bankruptcy estate was not a distribution from the bankruptcy estate to fall within I.R.C. section 1398, a payment from her ex-husband to fall under I.R.C. section 1041, or the sale of an inchoate marital right under *United States v. Davis*.[90] The district court noted that because the taxpayer sold to Tenneco her claims against the bankruptcy estate, she must recognize gain unless her basis in the claim was equal to or greater than the amount she received. However, because her claims against the bankruptcy estate had no basis, she must pay tax on the entire $5.75 million received. In affirming the decision of the district court, the Fifth Circuit noted that the taxpayer might have been entitled to treat such distribution as a nontaxable payment incident to divorce, pursuant to I.R.C. section 1041; however, the transaction between the taxpayer and Tenneco can be characterized "as nothing other than a garden variety sale on which [taxpayer] recognized substantial and immediate gain."[91]

(j) Abandonment of Property

As noted above, section 554(a) of the Bankruptcy Code provides: "After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." In situations where the value of the property is less than the amount of the secured claim and where the basis in the property is less than the value, a sale of the property or the transfer of the property to the creditor may result in a significant tax burden to the estate. To avoid this problem, the trustee often abandons the property.

Property may also be abandoned where the value of the collateral is greater than the debt, if the tax on the difference between the book value and the market value would be greater than the equity in the property. For example, assume

[88] The court cited *In re Maropa Marine Sales*, 92 B.R. 547 (Bankr. S.D. Fla. 1988); *In re Hutchinson*, 132 B.R. 827 (Bankr. M.D.N.C. 1991), *aff'd in part* F.3d 750 (4th Cir. 1993); and *In re Reich*, 54 B.R. 995 (Bankr. E.D. Mich. 1985).

[89] *Martin v. United States*, 97-2 U.S. Tax Cas. (CCH) 50,731, 80 A.F.T.R.2d (RIA) 6363 (E.D. La. 1997).

[90] 370 U.S. 65 (1962).

[91] *Martin v. United States*, No. 97-31277 (5th Cir. Nov. 12, 1998).

that property with a basis of $50 and a fair market value of $250 is sold to satisfy a debt of $200. The tax on the gain at a rate of 40 percent, $80 (($250 – $50) × .40), is greater than the equity in the property, $50.

The trustee's desire to abandon the property is based on the assumption that as a result of the abandonment there would be no gain or loss. I.R.C. section 1398(f) provides that the transfer of an asset to the estate from the individual is not to be considered as a disposition, that the estate shall be treated as the debtor would be treated with respect to that asset, and that "[i]n the case of termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition . . . and the debtor shall be treated as the estate would be treated with respect to such asset." I.R.C. section 1398(f) does not deal with the tax consequence when the property is transferred at a time other than termination of the estate.

(i) Argument for Taxable Event

Although it may appear that the trustee or even the debtor-in-possession might have a required obligation to abandon property that is either burdensome to the estate or of inconsequential value, case law and a careful reading of the statute may suggest that there are some limitations on this responsibility and that such an abandonment is a taxable event.

(A) Avoidance of Liability

In the case of *Midlantic National Bank v. New Jersey Department of Environmental Protection*,[92] the Supreme Court ruled that a bankruptcy trustee was not allowed to abandon real property when the effect of the abandonment was to relieve the estate on an environmental liability. This situation is not far from the situation faced by a trustee that has several pieces of property, some of which have large equity balances after paying taxes on the sale, with others resulting in a net cash outflow after taxes. However, taken as a group, sufficient cash will be realized to cover all of the tax liability arising on the disposition of the properties. If the only properties abandoned are those resulting in a tax liability larger than the net cash realized on sale of the properties, the IRS will not be able to collect the tax. The liabilities could be several million dollars and the debtor may be earning less than $50,000 per year.

(B) Denial of Fresh Start

Another reason to suggest that an abandonment of the property to the debtor by the trustee is a taxable event is that it does not limit opportunity of the debtor for a fresh start. If the abandonment to the debtor is not a taxable event, the tax on the subsequent sale or foreclosure of the property will deny the debtor a fresh start. Madoff suggests that the concept of giving the debtor

[92] 474 U.S. 494 (1986).

an opportunity for a fresh start has retained its importance after enactment of the Bankruptcy Code.[93]

In *In re A. J. Lane,*[94] the bankruptcy court held that where there is no other overriding policy, the fresh start policy is controlling. The court relied on *Local Loan Co. v. Hunt*[95] (fresh start policy supports an interpretation that invalidates debtor's assignment of future wages as security for debts discharged in bankruptcy) and *In re Lindberg*[96] (fresh start policy favors interpretation that permits debtors to claim new homestead exemption at time of conversion from chapter 13 to chapter 7). The court also noted that in *Segal v. Rochelle,*[97] the right to tax a refund due to loss carryback resulting from losses incurred prior to bankruptcy was deemed rooted in the debtor's past so that inclusion of the refund right in a bankruptcy estate is not violative of fresh start policy.

The court in *Lane* concluded:

> [T]axing the Debtor on the foreclosure following this proposed abandonment creates a clear burden on the Debtor's fresh start, and there is no countervailing policy which overrides this consideration. Enhancement of the distribution to creditors is of course also a basic policy of bankruptcy law. But here creditors are not significantly prejudiced if the gain is considered that of the estate. The estate can use the large net operating loss carryover which it inherited from the Debtor.

(C) Transfer as a Taxable Event

Courts have held for an extended time period that I.R.C. section 1001(a) provides, in a sale or exchange of property, including foreclosure, that the taxpayer is chargeable with income on the excess of the amount realized over the adjusted basis. The bankruptcy court in *Lane* reasoned that an abandonment is also a transfer, in the following passage:

> Foreclosure of a mortgage with recourse . . . is treated as a sale by the property owner notwithstanding the involuntary nature of the transaction. *Helvering v. Hammel*, 311 U.S. 504, 510, 85 L. Ed. 303, 61 S. Ct. 368 (1941). The same is true with respect to foreclosure of a mortgage or other lien where the holder of the lien has no recourse against the owner for a deficiency. *Helvering v. Nebraska Bridge Supply & Lumber Co.*, 312 U.S. 666, 85 L. Ed. 1111, 61 S. Ct. 827 (1941). The amount realized for income tax purposes in the sale of property subject to a nonrecourse mortgage equals the balance of the debt, whether the sales price is more or less than the debt or the property's value, and whether it is a sale to a

[93] Madoff, *A Reappraisal of the Tax Consequences of Abandonments in Bankruptcy,* 50 TAX NOTES 785, 788. Madoff cited the following cases: *In re Lindberg*, 735 F.2d 1087, 1090 (8th Cir.) ("one of the main goals of the Bankruptcy Code [is] to provide honest debtors with a fresh start"), *cert. denied,* 469 U.S. 1073 (1984); *In the Matter of Snider*, 102 B.R. 978, 989 (Bankr. S.D. Ohio 1989) ("the importance of the debtor's discharge is central to an individual's bankruptcy"); *In re Weatherspoon*, 101 B.R. 533, 541 (Bankr. N.D. Ill. 1989) (citing *Lines v. Frederick*, *supra note 62*); *In re Montoya*, 95 B.R. 511, 513 (Bankr. S.D. Ohio 1988) ("discharge . . . to be broadly construed to preserve the debtors' fresh start"); *In re Brzezinski*, 65 B.R. 336, 339 (Bankr. W.D. Wis. 1985) ("The essence of the Bankruptcy Code is to provide debtors with a fresh start"). 50 *Tax Notes* at 791.

[94] 133 B.R. 264 (Bankr. D.C. Mass. 1991).

[95] 292 U.S. 234, 244–245 (1934).

[96] Fed. Reg. S3300 (Nov. 9, 1992).

[97] 382 U.S. 375, 379–380 (1966).

> third party or a deed in lieu of foreclosure. *Commissioner v. Tufts,* 461 U.S. 300, 103 S. Ct. 1826, 75 L. Ed. 2d 863 (1983) (assumed nonrecourse mortgage exceeded value of property); *Crane v. Commissioner,* 331 U.S. 1, 67 S. Ct. 1047, 91 L. Ed. 1301 (1947) (property sold for more than nonrecourse debt); *Laport v. C.I.R.,* 671 F.2d 1028 (7th Cir. 1982) (deed in lieu of foreclosure). If the mortgage is with recourse, and the transaction involves satisfaction of the entire debt, the amount realized is also the full amount of the debt. *Chilingirian v. Commissioner,* 918 F.2d 1251 (6th Cir. 1990).[98]

In *Yarbro v. Commissioner*[99] the Fifth Circuit held that an abandonment was equivalent to the sale of the property. The taxpayer had invested in raw land whose value subsequently declined below the amount due on a nonrecourse bank mortgage incurred at the time of purchase. In 1976, the taxpayer notified the bank that he was abandoning the property due to the increased carrying costs; on his 1976 tax return, he claimed an ordinary loss. The taxpayer declined the bank's request for a deed in lieu of foreclosure because of a desire to have further involvement with the property. The bank foreclosed on the property the following year. The IRS objected to the ordinary loss deduction on the ground that the taxpayer had incurred a capital loss because the surrender itself was a sale.

The bankruptcy court in *Lane,* noting that it could "see no difference between the act of surrender before it and the deed in lieu of foreclosure involved in *Laport,*" reasoned that the court in *Yarbro* " . . . analyzed the transaction as a transfer of property by the taxpayer and the receipt of a benefit by him in the form of satisfaction of that portion of the debt equal to the property's value. It viewed that benefit as precisely the same as what was received by the taxpayer in *Nebraska Bridge Supply* through foreclosure of a nonrecourse tax lien. The court therefore held that the surrender constituted a sale or exchange."[100]

The court in *Yarbro,* according to *Lane,* "reasoned that both transactions are the functional equivalents of a foreclosure sale taxable to the owner under *Hammel* and *Nebraska Bridge Supply,* and that the taxpayer should not be able to change the tax consequences when the substance remains the same. It regarded the foreclosure which followed abandonment as merely a mechanical process to clear title."[101]

The bankruptcy court in *Lane* noted:

The reasoning in *Yarbro* is inescapable. In the abandonment of overly-encumbered property, as in the granting of a deed in lieu of foreclosure, a benefit is received in the amount of the secured debt which is discharged, the very same benefit which flows from the foreclosure of a nonrecourse mortgage. Where, as here, the debt is of the recourse variety, it is of course possible for borrower and lender to agree upon the discharge of the entire obligation so that the borrower receives that additional benefit. But this only changes the amount of benefit; it does not prevent the abandonment from constituting a sale. In declining to treat abandonment as a transfer taxable to the bankruptcy estate, the *McGowan* and *Olson* decisions . . . failed to recognize that the estate received a

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[98] *Supra* note 94, at 269–270.
[99] 737 F.2d 479 (5th Cir. 1984), *cert. denied,* 469 U.S. 1189 (1985).
[100] *Supra* note 94, at 270.
[101] *Id.*

benefit in the discharge of the secured portion of the debt. See *Samore v. Olson* (*In re Olson*), 100 Bankr. 458, 462–63 (Bankr. N.D. Iowa 1989), *aff'd,* 121 Bankr. 346, 348 (N.D. Iowa 1990), *aff'd,* 930 F.2d 6, 8 (8th Cir. 1991); *In re McGowan,* 95 Bankr. 104, 108 (Bankr. N.D. Iowa 1988).[102]

(D) Substance over Form

When abandonment occurs, the trustee is in many cases abandoning an asset to the debtor, which allows the creditor to foreclose on the property out-of-court rather than requiring the creditor to foreclose on the property in the bankruptcy court after requesting the court (1) to remove the stay and (2) to allow the foreclosure. The Supreme Court looked at the issue of substance over form on the transfer of property in *Commissioner v. Court Holding Co.*[103] *Court Holding* had negotiated an oral agreement to sell an apartment building, which was the corporation's sole asset, and had received a deposit from the purchaser. The corporation conveyed the building in a liquidating dividend to its two stockholders after being advised by counsel that a sale of the building by the corporation would create a large income tax liability. The stockholders then conveyed the building to the purchaser under the terms originally negotiated. The Supreme Court, holding that the transaction was taxable to the corporation, stated:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.[104]

The *Court Holding* doctrine has been applied in many other situations, as noted in *Lane.*[105] For example, in *Palmer v. Commissioner,*[106] the taxpayer owned property which he mortgaged as security for debt of his wholly owned corporation. He negotiated a sale of the property to obtain funds to reduce the debt, but, before the sale, the property was deeded to the corporation. The corporation made the sale in order to be taxed in a lower tax bracket. Based on the ruling in *Court Holding,* the court taxed the stockholder. The same result was reached in *Hallowell v. Commissioner,*[107] where the taxpayer transferred appreciated stock from his personal brokerage account to his 96 percent owned corporation, which sold the stock and reported the gain at its lower tax rate.

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[102] *Id.* at 270–271.
[103] 324 U.S. 331 (1945).
[104] *Id.* at 334.
[105] *Supra* note 94, at 271.
[106] 354 F.2d 974 (1st Cir. 1965).
[107] 56 T.C. 600 (1971).

A trustee, in abandoning assets, seeks to accomplish what was attempted in *Court Holding*—to transfer property already the subject of a foreclosure sale to another party (debtor) for the sole purpose of having the debtor taxed on the foreclosure.

(E) Section 1398(f)(2)

I.R.C. section 1398(f)(2) provides that "[i]n the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset."

The bankruptcy court in *Lane* noted that "the plain meaning of this provision is that it applies only to a transfer from the estate to the debtor at the termination of the estate."[108] *Lane* goes on to note that any possible doubt is resolved by comparing I.R.C. section 1398(i), which (except for substituting "an" for "the") uses the same phrase—"in the case of a termination of the estate"—in permitting the debtor to succeed to the estate's unused net operating loss carryovers and other tax attributes. It is clear that I.R.C. section 1398(i) applies to transfers at the end of the case—that is, on termination of the estate—and thus the same interpretation should be placed on I.R.C. section 1398(f) regarding the transfer of property.

The bankruptcy court concluded that the "design of the statute is clear. The party holding the property, whether the debtor or the estate, is also entitled to any available net operating loss carryover, so that if that party incurs a taxable gain in the disposition of the property he can use the net operating loss carryover to offset the gain."[109] As further noted by *Lane,* an abandonment of the property by the trustee would destroy this symmetry.

The court in *Lane* stated:

> Unfortunately, the decisions to date have ignored the interplay of subsections (f)(2) and (i). In *In re McGowan,* 95 Bankr. 104 (Bankr. N.D. Iowa 1988), at the request of the secured party, a chapter 7 trustee abandoned farm machinery in which the debtor had no equity. The trustee obliged the debtor by treating the abandonment as taxable to the estate, but the taxing authorities thought otherwise. Despite the overriding presence of the secured party, the court treated the abandonment as a nontaxable transfer to the debtor under section 1398(f)(2). The court believed that the phrase "termination of the estate" could have any one of a number of meanings—completion of administration of the entire estate, termination of the estate's interest in specific property through abandonment, or termination of the estate's interest in particular property through foreclosure. The court interpreted the phrase to include abandonment, without even mentioning subsection (i), much less recognizing the symmetry between it and subsection (f)(2). Surprisingly, in the interpretation of this tax statute the court was influenced by the broad definition of "transfer" contained in section 101(50) of the Bankruptcy Code. The court expressed concern that treating abandonment as taxable to the estate would reduce the dividend to unsecured creditors. It expressed no similar concern for the effect that the debtor's tax liability from an ensuring foreclosure would have upon his fresh start.[110]

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[108] *Supra* note 94, at 272.

[109] *Id.*

[110] *Id.*

(ii) Internal Revenue Service's Position

It has been the position of the IRS that, under the Bankruptcy Code, the transfer of the debtor's assets to the trustee or debtor-in-possession in bankruptcy is not a taxable event and that the estate succeeds to the debtor's basis, holding period, and character of assets. Also, it is the position of the IRS that the subsequent transfer of any surplus of a solvent estate to the individual is not a taxable event.[111]

As noted above, Treas. Reg. sections 1.1398-1 and 1.1398-2 provide (1) for the estate in a chapter 7 or chapter 11 case to succeed to the tax attribute of unused passive activity losses and credits and of unused losses under the at-risk rules of I.R.C. section 465, and (2) that a transfer of an interest in a passive activity or an at-risk activity under I.R.C. section 465 to the debtor as exempt under section 522 of the Bankruptcy Code or as abandoned to the debtor under section 554(a) of the Bankruptcy Code is a nontaxable transfer.

The IRS noted:

> [T]he proposed regulations provide such a transfer of an interest in a passive activity as defined in section 469(c) shall not be treated as a taxable disposition. This rule is consistent with the case law, which holds that the transfer (other than by sale or exchange) of an asset from the estate to the debtor before the termination of the estate is a nontaxable disposition. See, e.g., *In re Olson*, 100 B.R. 458 (Bankr. N.D. Ia. 1989), *aff'd*, 121 B.R. 346 (N.D. Ia. 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991).[112]

A similar statement is made in reference to the transfer of at-risk property under I.R.C. section 465.

This ruling is inconsistent with the bankruptcy court's decision in *Lane*,[113] where the bankruptcy court held that the abandonment was a taxable event. The IRS did not mention this case or *In re Larry F. and Mary A. Laymon*,[114] where the district court would not allow the debtor to abandon the property because of the potential adverse tax impact.

Treas. Reg. section 1.1398 makes it critical that the individual creditor owning several properties carefully examine the tax consequences of each before deciding to file a petition. In general, it is best for the debtor to transfer property that will result in a tax, that is, to sell the asset or transfer it to the creditor in full or partial settlement of the debt. The tax liability will then transfer to the estate if a short tax year petition is elected by the individual or if the taxable year ends before the petition is filed. Under these conditions, the tax liability is a liability of the estate; it will be a seventh priority and will be satisfied before any unsecured creditors will be paid. If there is a net operating loss (NOL), part or all of the tax liability may be absorbed by the NOL.

The other alternative is to file a chapter 11 petition and dispose of the properties that will result in a tax liability while the debtor is in control. For example,

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[111] *See* Rev. Rul. 78-134, 1978-1 C.B. 197.

[112] Carryover of passive activity losses and credits and at-risk losses to bankruptcy estates of individuals,

[113] *Supra* note 94.

[114] 1989 U.S. Dist. LEXIS 17345 (D.C. Minn. 1989).

if the case is converted to chapter 7 or a trustee is appointed in chapter 11, the property may be abandoned in order to maximize the fees that a trustee can earn by administering the estate.

Consider the following example of three properties (in 000s):

	Property I	Property II	Property III
Debt (recourse)	$10,000	$10,000	$10,000
Fair market value	4,000	11,000	13,000
Basis	3,000	3,000	15,000
Passive losses	400	200	50

The individual has a negative cash flow from the three properties and, as a result, is unable to make the required debt payments. The creditor of property I begins foreclosure action against the debtor and, as a result, the debtor files a chapter 7 petition. The debtor has $5 million in net operating losses. A trustee is appointed in the chapter 7 case and abandons property I and property II back to the debtor. The debtor allows the creditor to foreclose on property I or voluntarily transfers the properties to the creditor. As a result of the transfer, the taxpayer will have a gain (most likely capital, less any amount for recapture as ordinary income) of the difference between the amount of the debt and the basis of the property. Because the debtor is no longer personally liable for any deficiency, all of the gain will be gain on transfer and none of it will be income from debt discharge. Property II is sold for $11 million. The gains are as follows (in 000s):

	Property I	Property II	Total
Amount received	$10,000	$11,000	$21,000
Basis	3,000	3,000	6,000
Gain	$7,000	$8,000	$15,000

The gain will be reduced by the passive loss of $0.6 million. Assuming a 40 percent tax rate for both federal and state taxes, the debtor will have a tax obligation of $5.76 million. The individual has assets and will pay only a fraction of the $5.76 million tax debt over the next 10 years. If part of the gain is ordinary income due to recapture provisions, the taxpayer will not be able to offset this gain against the net operating loss because the net operating loss is one of the attributes that goes over to the estate as of the first day of the taxable year in which the bankruptcy petition is filed.

The estate will not have any tax liability. The cash realized from the sale of property III ($3 million) will be used to pay the trustee's fees and the professional fees of the attorney and accountant; the balance will go to unsecured creditors. The individual with no assets has a tax claim of $5.76 million.

If the properties are sold, whether before or after the petition is filed, the gain on the transfer will be less because the income from debt discharge will be reported on the transfer of property I. The gains from the voluntary transfer of property I to the creditor for full settlement of the claim and from the sale of

both property II and property III for their market values, will be as follows (in 000s):

	Property I	Property II	Property III	Total
Amount received	$10,000	$11,000	$13,000	$34,000
Basis	3,000	3,000	15,000	21,000
Total gain	$7,000	$8,000	$(2,000)	$13,000
Debt discharge	$6,000	0	0	$6,000
Gain on transfer	$1,000	$8,000	$(2,000)	$7,000

If the debtor transfers property I to the bank and sells property II before the petition is filed, the tax claim will be much less because $6 million of the gain will be considered income from the discharge of debt. The total tax will be $3.6 million ($9 million times the 40 percent tax rate) before any benefit from the net operating loss carryover, if any, and the benefit of the passive loss carryover. This $3.6 million tax claim will go to the estate provided the debtor elects to file a short tax year return or the bankruptcy petition is filed after the end of the tax year in which the transfer occurs. During the case, interest and penalties will not accrue on the tax. However, if the tax claim is not paid by the estate, it will not be discharged.

However, if the debtor files a chapter 11 plan and then transfers the property as described above, the tax liability before any benefit from net operating losses and the unused passive activity losses will be only $2.8 million ($7 million x the 40 percent tax rate). This is a tax obligation of the estate and, if the claim is not paid by the estate due to a lack of assets, the liability will not transfer back to the debtor. However, in this example, the estate has cash in the amount of $4 million from the sale of the properties and will be able to pay the tax liability.

The debtor might also want to consider the option of keeping property III and developing a plan that calls for the payment of tax over 6 years where the payments are not necessarily the same each year.

In a Private Letter Ruling,[115] the IRS has ruled that the abandonment of an asset from the bankruptcy estate to the debtor was not a sale or other disposition.

In another Private Letter Ruling,[116] the IRS adopted the basic conclusions in *In re David Roger McGowan.*[117] However, it held that the recourse debt became nonrecourse as a result of the discharge in bankruptcy. In this ruling, the debtor received a discharge shortly after the abandonment of a farm property. The debtor continued to farm the property 3 years before the foreclosure occurred. As a result of the conversion of the debt from recourse to nonrecourse, all of the gain—difference between the basis in the property and amount of the debt discharged—was considered gain on exchange and none of the gain would be considered income from debt discharge.

[115] Private Letter Ruling 9245023 (August 7, 1992).
[116] Private Letter Ruling 8918016, (Jan. 31, 1989).
[117] 95 B.R. 104 (Bankr. S.D. Iowa 1988).

(iii) Court Rulings

The courts are split on the issue of how abandonments should be handled. In *McGowan,*[118] the bankruptcy court held that the abandonment of the property by the trustee was not a sale or exchange and that termination of the estate could in fact cover abandonments.

The trustee abandoned property subject to an undersecured debt where the market value of the property was greater than the basis. The trustee filed a tax return on the assumption that the abandonment was taxable to the estate and requested a determination of the tax. The bankruptcy court expressed concern that the trustee, by taking the position that the event was taxable, was not acting in the best interest of the estate and appeared to be more concerned with protecting the debtor. The court failed to acknowledge that the trustee was following the provisions of I.R.C. section 1398(f)(2), which provides that the transfer is not taxable upon termination of the estate.

The bankruptcy court noted in *McGowan* that I.R.C. section 1398(f)(2) does not define the term "termination of the estate" and that the term is open to several interpretations:[119]

> This term could mean the closing of a case after full administration of the estate; a termination of the estate's interest in property by virtue of abandonment or exemption; the termination of the estate's interest in property as a result of completed state or federal court proceedings following modification or termination of the automatic stay if such proceedings terminate the estate's interests under state law. It could have other meanings.

In *In re Olson,*[120] the bankruptcy court (same judge) relied on *McGowan,* but acknowledged that *McGowan* might have been overly broad by including abandonment as involving termination of the estate. In *Olson,* the court stated that "[t]he definition of 'transfer' within the Bankruptcy Code is broad enough to encompass abandonments, and section 1398(f)(2) . . . enables the court to determine the liability issue. The court concludes from the foregoing that the abandonment by the trustee was a transfer other than by sale or exchange which is excepted from tax consequences under . . . section 1398(f)(2)."

The court then concluded without analysis that the meaning of "termination of the estate" includes the termination of the estate's interest in property pursuant to section 554(a) of the Bankruptcy Code, which provides for the abandonment of property that is burdensome to the estate or of inconsequential value.

The court acknowledged that a better definition of "termination of the estate" might be the closing of the case, but it refused to adopt this position. The court was concerned that if a "closing of the estate" definition was followed, no tax liability would be imposed if the property were left in the estate at the close of the case. The court noted, however, that a tax liability would be imposed if the property were abandoned during the administration of the case. The court could see no reason why abandonment during administration of a case should have a different tax effect and, thus, found that abandonments during administration of

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[118] *Id.*

[119] *Id.* at 107.

[120] 100 B.R. 458 (Bankr. N.D. Iowa 1989), *aff'd,* 121 B.R. 346 (N.D. Iowa 1990).

a case also should be covered by I.R.C. section 1398. Based on this logic, it would appear that the court would conclude in a situation as illustrated above, where the estate has the funds to pay the taxes and the debtor does not, that the abandonment should be taxable.

On appeal, the district court and the Eighth Circuit in *In re Olson*[121] held that abandonment is not a sale and therefore is not a taxable event for the State of Iowa.

In both *McGowan* and *Olson,* the court refused to apply the analysis made in *Yarbro,* where the court identified three things that are required for an exchange:

> A giving, a receipt, and a causal connection between the two. In the case of abandonment of property subject to nonrecourse debt, the owner gives up legal title to the property. The mortgagee, who has a legal interest in the property, is the beneficiary of this gift, because the mortgagee's interest is no longer subject to the abandoning owner's rights.[122]

In both *McGowan* and *Olson*, the bankruptcy court refused to apply the *Yarbro* analysis to abandonments of property during bankruptcy. The courts took the position that, although the trustee receives relief from the obligation to administer property which, if overencumbered, would provide no assets for distribution in the bankruptcy case, that kind of benefit is not the kind of benefit necessary to an exchange. Because the trustee did not receive anything by virtue of the abandonment, one of the essential elements of an exchange is missing.

Madoff noted that the courts' conclusion that the "trustee's relief from the obligation to administer property is not a sufficient benefit to warrant an 'exchange' indicates a misunderstanding of the exchange analysis by focusing on the trustee as the exchanging party instead of the estate."[123] A careful analysis of the components of the exchange indicates that the abandonment of encumbered property from an estate to a debtor does meet the requirements for an exchange.

Madoff provides the following analysis of the courts' ruling regarding *Yarbro:*

> Prior to the abandonment of property, a creditor with an undersecured claim has a secured claim against the estate up to the fair-market value of the property and an unsecured claim against the estate equal to the excess of the amount of debt over the fair-market value of the property. For example, if property has a fair-market value of $30 and is subject to debt of $40, that creditor has a secured claim against the estate for $30 and an unsecured claim against the estate for $10. By abandoning the property to the debtor, the estate transfers legal title to the property to the debtor in exchange for relief from the $30 secured debt. There is clearly a causal connection between the abandonment of the property and relief from the secured claim because relief from the liability could not occur but for the transfer of the property. [Footnotes omitted][124]

Madoff then noted that there is a difference in the transfer of the property to the estate and the transfer of the property to the debtor:

> When property is abandoned by the estate to the debtor, the estate is giving legal title to the property, receiving relief from the obligation to pay the

[121] 121 B.R. 346 (Bankr. N.D. 1990), *aff'd,* 930 F.2d 6 (8th Cir. 1991).
[122] *Supra* note 99, at 483–484.
[123] *Supra* note 93, at 790.
[124] *Id.* at 790–791.

> secured claim, and there is a causal connection between the two. Compare this to what happens when property is transferred from a debtor to the estate at the commencement of the case. In that situation, the debtor is still giving legal title to the estate; however, unlike in the abandonment situation, the transferor is not receiving relief from the indebtedness. All that happens upon the commencement of the case is that an automatic stay is imposed on claims against the debtor and the debtor's property. The debtor will not receive any relief from indebtedness until the date of discharge at the close of the case. Moreover, even if the debtor were receiving relief from indebtedness, there is no causal connection between the transfer of the property to the estate and the relief of indebtedness. Any relief from indebtedness occurs by virtue of operation of the bankruptcy law. It operates independently of any transfers of property by the debtor to the estate.[125]

In *In re A. J. Lane & Co.*,[126] the bankruptcy court examined the issue of property abandonment and raised some interesting questions. Stanley Miller, the chapter 11 trustee in several consolidated cases, requested authority to abandon three properties: the Chapel Hill Apartments in Framingham, Massachusetts; the Cliffside Apartments in Sunderland, Massachusetts; and the partnership interest of the principal debtor, Andrew J. Lane, in Fountainhead Associates of Westborough, a partnership that owns the Fountainhead Apartments in Westborough, Massachusetts. The debtor objected on two grounds:

1. The statutory requisites for abandonment are not present;
2. Should abandonment be otherwise permissible, it would shift foreclosure tax consequences from the bankruptcy estates to the debtor and would destroy the debtor's opportunity for a fresh start.

At the time of the trustee's notice of intention to abandon, First Mutual Bank of Boston (First Mutual), the holder of second mortgages with recourse rights, had been granted relief from the automatic stay and had scheduled foreclosure sales of all three apartment complexes. The trustee's sole reason for abandoning the properties was to avoid the substantial income tax liability that would be incurred by the bankruptcy estates, should the estates be considered owners at the time of the foreclosure sales. At the hearing, it was estimated that the properties had a total fair market value of $53 million and a present tax basis of $12.1 million, so that the foreclosure sales would produce a gain of $40.9 million and a tax liability for the estates of $3.27 million considering the tax benefit of a substantial operating loss carryforward available to the estates. It was also pointed out in the hearing that if the debtor bore the tax consequences, the tax liability would total around $13 million because the net operating loss carryforwards would not be available to the debtor until the bankruptcy estates were closed.

After the hearing, the trustee and the debtor were able to obtain refinancing for the Fountainhead and Chapel Hill Apartments and avoid the foreclosure. Thus, the trustee accordingly withdrew his request to abandon those two properties.

The court concluded that an abandonment of property is a transfer that is taxable. First, the bankruptcy court cited *Yarbro v. Commissioner*.[127] Second, the

[125] *Id.* at 791.
[126] *Supra* note 94.
[127] *Supra* note 99.

court relied on *Commissioner v. Court Holding Co.,*[128] where the Supreme Court treated the corporation as having made the sale for tax purposes even though its stockholders actually transferred title to the purchaser to decide that the estate is responsible for the tax. The court noted:

> The Trustee seeks to accomplish here what was attempted in Court Holding—to transfer property already the subject of a sales transaction to another party for the sole purpose of having the other taxed on the sale. Here, a foreclosure sale rather than a negotiated sale was pending, but there is no difference in the sale. Here, a foreclosure sale rather than a negotiated sale was pending, but there is no difference in substance. As in Court Holding, the purchaser and the terms of the sale remained unchanged.[129]

The bankruptcy court then examined I.R.C. section 1398(f)(2) and concluded that the plain meaning of the section is that it applies only to a transfer from the estate to the debtor at the termination of the estate. The court noted that the design statute is clear:

> The party holding the property, whether the debtor or the estate, is also entitled to any available net operating loss carryover, so that if that party incurs a taxable gain in the disposition of the property he can use the net operating loss carryover to offset the gain. The Trustee's proposed abandonment would destroy this symmetry. If the proposed abandonment here were considered to run to the Debtor for title and tax purposes and be tax-free, so that the Debtor would acquire the same low basis in the property as that enjoyed by the estate, the Debtor would incur a large gain from the foreclosure sale without having the net operating loss carryover available to offset that gain. That would be particularly unfair here. The Debtor estimated that imposition to the estate of the gain on foreclosure of all three properties would have resulted in a tax of $3.27 million, whereas if the Debtor were charged with the gain he would have to pay a tax of about $13 million. Although we do not have the parties' estimates of the tax that would be payable by the Debtor if foreclosure on the Cliffside Apartments alone is taxable to him, it is conceded that the tax would be substantial. The doctrine of either *Yarbro* or *Court Holding* would avoid this. Under *Yarbro,* abandonment is considered a taxable event; under *Court Holding,* the estate is treated as the seller in the foreclosure. In either case, the estate could use the net operating loss carryover to offset its gain.[130]

The *Lane* court was the first court that concluded that the estate will be taxed if the property is abandoned. Judge Queenan's analysis of I.R.C. section 1398 (which was discussed in detail above) deserves careful consideration. Why should the entity with the tax attributes be able to force the other party to pay the tax on abandoned property? I.R.C. section 1398 avoids this problem by indicating that only on termination of the estate will transfers back to the debtor not be taxed.

In *In the matter of Donovan Feilmeier*[131] the bankruptcy court held that once property is no longer the property of the estate due to the release of the stay in a chapter 11 case, any taxes arising from the sale of the debtor's property is the obligation of the debtor, not the obligation of the estate.

The bankruptcy court in *In re Larry F. and Mary A. Laymon*[132] refused to allow the abandonment in a special situation.

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[128] *Supra* note 103.
[129] *Lane, supra* note 94, at 272–273.
[130] *Id.* at 223.
[131] No. BK85-2889 (Bankr. D. Nebr. Nov. 25, 1991).
[132] *Supra* note 114.

Larry and Mary Laymon farmed several parcels of agricultural land in Minnesota. On July 20, 1987, they filed a chapter 7 petition. Two nonhomestead parcels of farmland had a basis of only $1,500 and a value of approximately $100,000 with a mortgage of $196,000. After the petition was filed, the chapter 7 trustee rented out the farmland in 1987 and 1988 for approximately $22,000. The holder of the mortgage obtained a lift of the automatic stay and commenced foreclosure proceedings. It appeared that the first attempt to sell the property was deficient in some aspect and a second foreclosure sale was noticed. Before the second sale, a new trustee was appointed to administer the estate. He determined that the sale of the property would result in a capital gains tax of approximately $17,000 if the estate possessed the property at the time of the sale. As a result, he sought to abandon the property before the sale. Prior to the sale of the property, the bankruptcy court approved the abandonment of the property.

In *Laymon,* the trustee claimed that the property was burdensome because the capital gains tax would reduce the assets which otherwise would be available for creditors. The Laymons objected to abandonment as improper and inequitable because the estate enjoyed a great benefit from the property before abandonment, such as the receipt of $22,000 in the form of rental income. The district court noted that, in *In re Wilson,*[133] it was stated that a court looking at the abandonment issue should consider whether the decision "reflects a business judgment made in good faith, upon a reasonable basis and with[in] the scope of his authority under the code."

The trustee argued that abandonment is consistent with his fiduciary obligation to creditors—to preserve for the creditors the largest possible estate. The district court noted, "[t]hat is not a trustee's sole fiduciary obligation, however. As a successor to the debtor's interest in estate property, the trustee has duties to all the parties, such as administering the estate fairly and closing it expeditiously." The court also noted that the trustee has a more general duty not to burden unduly the debtor's opportunity for a fresh start. In citing *In the Matter of Esgro, Inc.,*[134] the court noted that "a primary goal of the Bankruptcy Code is to relieve debtors from the weight of oppressive indebtedness."

The court also noted that the "impact that abandonment would have upon debtors is one aspect to consider on the issue of burdensomeness." The court concluded that "[i]n the circumstances presented, it was erroneous for the bankruptcy court to approve the trustee's report of abandonment and that order should be reversed."

This case does not necessarily indicate that if the tax burden interferes with the ability of the debtor to obtain a fresh start, the property should not be abandoned. It does indicate that some consideration in making the abandonment decision should be given to the impact that the action will have on the debtor. This case may also suggest that if abandonment is to take place, the trustee should abandon the property shortly after the chapter 7 petition is filed rather than making the abandonment just prior to sale to avoid the tax. This decision should encourage trustees to determine at the beginning of the case those

[133] 94 B.R. 886, 888–889 (Bankr. E.D. Va. 1989).

[134] 645 F.2d 794, 748 (8th Cir. 1981).

properties that have a low basis relative to value. Properties that may result in a significant tax burden for the estate should be abandoned at the beginning of the case unless the benefits in holding them outweigh the tax costs. In *Laymon,* the estate was burdened with the potential tax liability because the value of the rents received exceeded the tax.

In *In re Nevin,*[135] the bankruptcy court ordered the trustee to abandon to the debtors their respective partnership interests in the limited partnerships. The order came after the IRS filed a motion for abandonment. The limited partnership filed a chapter 7 petition and ceased operating its restaurant. The bankruptcy court approved the sale of the restaurant which resulted in a federal tax liability of approximately $100,000 to the partners.

The partners are in chapter 7 in a "no asset" case, and there are no funds in the estates of the individuals to pay the tax liability, but there are funds in the partnership to pay the taxes.

The court noted that the Bankruptcy Code requires that the trustee in a chapter 7 liquidation case expeditiously liquidate the property of the estate or abandon it.[136] Citing *Mason v. Commissioner,*[137] the court noted that the abandonment of property relates back to the inception of the bankruptcy case and will revest title in the debtor as though the trustee never owned it. The court noted that the debtors chose the partnership form of business organization when they formed the restaurant and that, if they had selected a corporate form of ownership, they would not have become faced with the present dilemma. The court also noted that they had apparently chosen the partnership form in order to obtain the tax benefits of partnership.

Generally, in determining if property should be abandoned, the trustee need only consider if the asset has value to the estate. It is not necessary for the trustee to consider any adverse tax consequences to the debtor resulting from abandonment of the property.[138]

(iv) Abandonment to Debtor or Creditor

In *In re Popp,*[139] the bankruptcy court held that the trustee may only abandon the property to the debtor because the debtor has a possessory interest in the assets that is superior to all third parties. Section 554(b) of the Bankruptcy Code states: "On request of a party in interest . . . the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." The legislative history of section 554 of the Bankruptcy Code states: "Abandonment may be to any party with a possessory interest in the property abandoned."[140] The bankruptcy court

[135] 135 B.R. 652 (Bankr. D. Hawaii 1991).
[136] *See, e.g., In re Groves*, 120 B.R. 956 (Bankr. N.D. Ill. 1990); and as noted in *In re Wilson*, 94 B.R. 886, 889 (Bankr. E.D. Va. 1989).
[137] 68 T.C. 163 (1977), *aff'd,* 646 F.2d 1309 (9th Cir. 1980).
[138] *Johnston v. Webster*, 49 F.3d 538 (9th Cir. 1995).
[139] 166 B.R. 697 (Bankr. D. Neb. 1993).
[140] H.R. REP. NO. 595, 95th Cong., 1st Sess. 377 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 92 (1978).

in *In re Popp* noted that in *Black's Law Dictionary*[141] a "possessory interest" is defined as a "right to exert control over specific land to the exclusion of others" or a "right to possess property. "

As a result of section 554(b) of the Bankruptcy Code and the related legislative history, courts have generally held that abandonment should be to the party with the superior possessory interest.[142] The bankruptcy court in *Popp* also relied on the rule that the Supreme Court first presented in *O'Keefe,* when analyzing the rights of the parties under the Bankruptcy Act of 1898. The Supreme Court noted that once the trustee abandons property of the estate, the property is treated as though no bankruptcy had been filed, and interest in the property reverts back to the party that held such interest prepetition.[143] As a result of these cases, it is generally concluded that the party that has the right to possession at the filing of the bankruptcy will reassume the same status when the asset is abandoned. As a general rule, that will normally be the debtor. However, a creditor may be entitled to possession if, by the exercise of its contractual or other rights, it held a possessory interest prior to the filing of the bankruptcy. For example, in the case of *In re A. J. Lane & Co.*[144] the bankruptcy court held that a secured creditor had a superior possessory interest because the creditor had already been granted relief from the automatic stay and was free to foreclose on its mortgage.

In order for the creditor to have a superior possessory interest over the debtor, it may be necessary for the secured lender to be in possession of the property prior to the filing of the petition. For example, in *In re Service,*[145] the bankruptcy court held the debtors could not propose to abandon property to the secured party because the secured party was not in possession of the property prepetition. Likewise, in *Popp,* the bankruptcy court held that the bank did not have possession of the assets at the filing date and that, as a result, the trustee may not abandon to the creditor but must abandon to the debtor. The court concluded that the debtor will retain title and all other benefits and detriments concerning the equipment that is abandoned by the trustee.

However, in *In re Terjen,*[146] the bankruptcy court held that the individual and not the bankruptcy estate was liable for taxes where the trustee abandoned property after creditors were afforded relief from the bankruptcy stay but before a foreclosure sale was held. The decision by the district court does not examine who has possessory interest in the property before it is abandoned or at the time the petition is filed.

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[141] *Black's Law Dictionary* 1049 (5th ed. 1979).

[142] *In re Perry*, 29 B.R. 787, 793 (D. Md. 1983), *aff'd* 729 F.2d 982 (4th Cir. 1984); *In re Cruseturner*, 8 B.R. 581, 591 (Bankr. D. Utah 1981).

[143] Brown v. O'Keefe, 300 U.S. 598 (1937); *Wallace v. Lawrence Warehouse Co.*, 338 F.2d 392, 394 n.l (9th Cir. 1964).

[144] 133 B.R. 264, 269 (Bankr. D. Mass. 1991), *aff'd* 50 F.3d 1 (1st Cir. 1995).

[145] 155 B.R. 512, 515 (Bankr. E.D. Mo. 1993), *aff'd* 1994 U.S. App Lexis 20711 (4th Cir. 1994).

[146] 154 B.R. 456 (E.D. Va. 1993), *aff'd,* 30 F.3d 131 (4th Cir. 1994).

(k) Abandonment of Proceeds

If the trustee sells the property and then abandons the proceeds, it would appear that any gain that might be realized on the sale is reported by the estate. In *In re Bentley*,[147] the trustee sold collateral (grain) for an undersecured claim (apparently hoping that the estate might have some equity) and held the proceeds of the sale for three years. Then the trustee abandoned the proceeds. The bankruptcy court held that the sale did not result in "gross income of the debtor to which the estate is entitled" under I.R.C. section 1398(e). The court concluded that the estate was not entitled to and ultimately did not retain the property and received no benefit from the property. Thus, this was not a taxable event to the estate. On appeal by the IRS, the district court reversed the bankruptcy court's decision and held that abandonment of grain sale proceeds by a trustee in bankruptcy may not relate back 3 years so as to constitute a retroactive abandonment of the grain itself, which would have absolved the bankruptcy estate of tax liability. The court further stated that the taxable event occurred when the grain was sold.[148] The *In re Bentley*[149] case was affirmed by the Court of Appeals for the Eighth Circuit, which ruled that the gain on sale of the corn does not give rise to a tax obligation of the individual debtor.

The bankruptcy court ruled that a trustee may not abandon the proceeds of sales of estate property to avoid the tax consequences of the sales. The individual debtor filed a chapter 7 petition in 1991 owning an interest in a partnership. The partnership owned an interest in a wrap-around mortgage encumbering real property, and an equity interest in an apartment complex. The partnership had sold its interest in two other properties prior to debtor's bankruptcy filing. In 1992, the bankruptcy court authorized the sale of the wrap-around mortgage and the apartment complex, netting over $47,000 for the debtor's estate in 1992. The trustee filed a motion to abandon the proceeds from those sales because the estate might incur substantial tax liabilities resulting from the sales. The IRS objected to the motion.

Citing *In re Bentley*,[150] where the Eighth Circuit held that the trustee's sale of estate assets was a taxable event for which the bankruptcy estate was liable and the trustee's abandonment of the sale proceeds did not abrogate the tax consequences of the sale, the bankruptcy court held that the trustee could not retroactively abandon the estate's interest in the partnership. The court noted that the estate's interest in the partnership could have been abandoned prior to the sales under section 554(a) of the Bankruptcy Code without any tax consequences and rejected as irrelevant the trustee's argument that he did not know the tax consequences would be so significant because the debtor's records were in disarray and the debtor had not filed prior year's tax returns.[151]

[147] 79 B.R. 413 (Bankr. S.D. Iowa 1987).
[148] 89-2 USTC (CCH) 9597.
[149] 916 F.2d 431 (8th Cir. 1990).
[150] 916 F.2d 431 (8th Cir. 1990).
[151] *In re Perlman*, 188 B.R. 704 (Bankr. S.D. Fla. 1995).

§ 4.4 ACCOUNTING FOR THE DEBTOR (INDIVIDUAL)

Under prior law, as was discussed previously, considerable confusion existed as to the taxability of the operations of the individual debtor during the bankruptcy proceedings. Section 1398 was added to the Internal Revenue Code as a result of the Bankruptcy Tax Act of 1980, to provide guidelines for the tax treatment of the individual debtor during the time period in which bankruptcy proceedings are pending and for the handling of items at the conclusion of the bankruptcy proceedings.

(a) Individual Debtor's Taxable Year

One of the questions that always arises in considering an individual's tax liability in bankruptcy proceedings is what impact the event of bankruptcy had upon the debtor's taxable year. Under prior law, the debtor's taxable year did not terminate at the time the bankruptcy petition was filed. Thus, all the property of the debtor could be transferred to the estate, and at year-end the debtor would be left with a large tax liability, assuming income was earned prior to the filing of the bankruptcy petition. Thus, a potential hardship to the debtor could exist.

To alleviate this problem, a major change was made by the Bankruptcy Tax Act. The new act gave individual debtors an election to close their taxable year as of the day before the date bankruptcy commences.[152] This election is available to individuals in either chapter 7 or chapter 11 proceedings. Also, this election should be available to an individual that filed a chapter 12 petition, if it is assumed that a new entity is created (see § 4.3(a)). However, since I.R.C. section 1398 was not modified to include this provision, such an election is not available for federal tax purposes because a separate estate is not created.

If the taxpayer does make the election to close the taxable year, the taxpayer's taxable year is divided into two "short" taxable years. For example, if a calendar-year taxpayer filed a petition on July 15, the first "short" year would be from January 1 through July 14, and the second "short" year from July 15 through December 31. The tax liability computed for the first short year is collectible from the bankruptcy estate. The tax is considered a liability before bankruptcy and thus payable by the estate. In the event the estate does not possess enough assets to pay the tax, the remaining liability, as is true with any priority tax, is not discharged, but is collectible from the individual after the case terminates.[153] If the individual has earned income up to the date the petition is filed and has net operating losses, the individual could file the short tax return and then offset the income earned during the short year against the net operating loss. Then, the balance of the net operating loss after this adjustment would be carried over to the estate as of the date the bankruptcy petition is filed (see § 4.3(c)).

If the debtor does not make the election, courts have held that the tax liability for the entire tax year is an obligation of the debtor. For example in *In re*

[152] I.R.C. § 1398(d)(2)(A).
[153] 11 U.S.C. § 523(a)(1).

Mirman,[154] the court noted that, under sections 502(i) and 507(a)(7)(A) of the Bankruptcy Code, the taxes are not a liability until the end of the year even though the source of income that gave rise to the taxes was received prior to the filing of the bankruptcy petition. The court held that "the Internal Revenue Service is not a creditor of the debtors' bankruptcy estate. The IRS holds a valid claim against the debtors individually for the taxable year 1982, but since the debtors failed to make an election under 26 U.S.C. 1398(d) to divide their taxable year, no part of the debtors' tax liability for the year is collectible from the estate." It is also the position of the Service that taxes on income earned before the petition was filed, but in the year of filing, where the debtor does not make the section 1398 election are not subject to discharge and the IRS may initiate collection procedures against the debtor outside bankruptcy after the automatic stay terminates.[155]

Also, in *In re Turboff*,[156] the court refused to allow the estate to make estimated tax payments to avoid interest and penalties for taxes of the individual due in the year a bankruptcy petition was filed. The debtor failed to make the timely election under I.R.C. section 1398(d)(2) to close the taxable year the day before the case was commenced. However, in *In re Eith*,[157] where the debtor timely prepared the tax return making the short-year election under I.R.C. section 1398(d)(2) and gave it to the trustee, who did not timely file it, the court allowed the estate to pay the prepetition taxes that were the personal liability of the debtor. The trustee had demanded that the return be sent to him for filing, arguing that any tax refund was that of the estate. The trustee, for reasons unknown, did not file the return before the deadline had passed. The taxes were allowed as an administrative expense of the estate.

The Tax Court held that a couple could not use a net operating loss to reduce their income for the year in which the husband filed a voluntary bankruptcy petition, because the husband did not elect to adopt a short taxable year ending on the date before his filing.[158]

(i) Procedures for Election

This election is available to an individual taxpayer who files a chapter 7 or chapter 11 petition after March 24, 1981. Treas. Reg. section 301.9100-14T provides that a taxpayer to whom the election is available makes the election by filing a return for the short taxable year ending the day before commencement of the case (the "first short taxable year") on or before the fifteenth day of the fourth full month following the end of that first short taxable year. The spouse of such a taxpayer makes the election by making a joint return with the taxpayer for that first short taxable year within the time prescribed in the preceding sentence. To facilitate processing, Treas. Reg. section 301.9100-14T directs the taxpayer to write "SECTION 1398 ELECTION" at the top of the return. A taxpayer may

[154] 98 B.R. 742 (Bankr. E.D. Va. 1989).
[155] ILM 199910005; LTRServ, Mar. 22, 1999, p. 2103.
[156] 93 B.R. 523 (Bankr. S.D. Tex. 1988).
[157] 111 B.R. 311 (Bankr. D. Haw. 1990).
[158] *Kahle v. Commissioner*, T.C. Memo. 1997-91; 73 T.C.M. (CCH) 2080.

also make the election by attaching a statement of election to an application for extension of time for filing a return that satisfies the requirements under I.R.C. section 6081 for the first short taxable year. The application for extension must be submitted under I.R.C. section 6081 on or before the due date of the return for the first short taxable year. The statement must state that the taxpayer elects, under I.R.C. section 1398(d)(2), to close the taxable year as of the day before commencement of the case. If the taxpayer's spouse elects to close his or her taxable year, the spouse must join in the application for extension and in the statement of election. If a joint return is not filed for the first short taxable year, the election of the spouse made with the application is void.

Treas. Reg. section 301.9100-14T provides that the election, once made, is irrevocable.

A debtor's spouse who subsequently files a chapter 7 or chapter 11 petition in the same taxable year can make the election even if the spouse joined in the debtor's election earlier. Also, the debtor, provided otherwise eligible to file a joint return with the spouse, may join in the election. The following example was provided in Treas. Reg. section 301.9100-14T:

1. Assume that husband and wife are calendar-year taxpayers, that a bankruptcy case involving only the husband commences on March 1, 1982, and that a bankruptcy case involving only the wife commences on October 10, 1982.
2. If the husband does not make an election, his taxable year would not be affected; i.e., it does not terminate on February 28. If the husband does make an election, his first short taxable year would be January 1 through February 28; his second short taxable year would begin March 1. The tax return for his first short taxable year would be due on June 15. The wife could join in the husband's election, but only if they file a joint return for the taxable year January 1 through February 28.
3. The wife could elect to terminate her taxable year on October 9. If she did, and if the husband had not made an election or if the wife had not joined in the husband's election, she would have two taxable years in 1982—the first from January 1 through October 9, and the second from October 10 through December 31. The tax return for her first short taxable year would be due on February 15, 1983. If the husband had not made an election to terminate his taxable year on February 28, the husband could join in an election by his wife, but only if they file a joint return for the taxable year January 1 through October 9. If the husband had made an election but the wife had not joined in the husband's election, the husband could not join in an election by the wife to terminate her taxable year on October 9, since they could not file a joint return for such year.
4. If the wife makes the election relating to her own bankruptcy case, and had joined the husband in making an election relating to his case, she would have two additional taxable years with respect to her 1982 income and deductions—the second short taxable year would be March 1 through October 9, and the third short taxable year would be October 10 through December 31. The husband could join in the wife's election if

they file a joint return for the second short taxable year. If the husband joins in the wife's election, they could file joint returns for the short taxable year ending December 31, but would not be required to do so.

(ii) Electing "Short" Tax Year

In most cases, it would be presumed that the debtor would make the short tax year election if income was earned as of the date the petition was filed and would not make the election if there was a loss for this time period. If the debtor makes the election and, as a result of filing the short period return, ends up with a refund, it would appear that the refund would be property of the estate. The debtor cannot be forced to make the election, but once the election is made, then it would seem that he would lose all rights to the tax refund.

If the debtor is married, the spouse can join in the election. Under these conditions, a joint return would have to be filed for the short taxable year ending when the petition was filed. A spouse joining in the filing of the short tax return would transfer any individual tax liability to that of the bankruptcy estate.

In making a decision as to whether a short tax return should be filed, the debtor will need to consider the fact that the basis of assets is transferred over to the estate as of the first day of the taxable year in which the petition was filed. Thus, if the short tax return is not filed, the individual, it appears, would not have any depreciation deduction for the assets that were transferred to the estate. To obtain the depreciation deduction, the individual would have to file a short tax return (see § 4.3(c)). Another factor to consider in electing whether to file a short tax return is the method by which tax liability is determined. If a short tax return is filed, any litigation associated with the taxes due under that return would be handled by the bankruptcy court. However, if the debtor elected not to file a short tax return, any dispute concerning that return would be handled by the Tax Court (see § 8.5(b)). In filing a return for either short period—the one up to the date the bankruptcy petition was filed or the period from the date the bankruptcy petition was filed to the end of the tax year—the debtor must annualize income and make the other adjustments that are required under I.R.C. section 443.[159]

(b) Tax Refunds and Estimated Tax Payments

Even if a short tax return is not filed, there may be a question as to whether the estate or an individual is entitled to a tax refund that is primarily based on post-bankruptcy activities. Under the prior bankruptcy law, the Supreme Court held in *Segal v. Rochelle*[160] that the loss carryback refund claim was property of the bankruptcy estate at the petition date. Other courts have held that the refunds due the individual debtor should be apportioned between the debtor and the estate.[161] The basis of the apportionment was the salary earned and the normal

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[159] Berenson and Honecker, *supra* note 51, at 279.

[160] 382 U.S. 375 (1966). *See also In re C. A. Searlies*, 445 F. Supp. 749 (D.C. Conn. 1978).

[161] *In re James*, 337 F. Supp. 620 (D.C. Minn. 1971); *In reGriffin*, 1 B.R. 653 (Bankr. M.D. Tenn. 1979); *In re DeVoe*, 5 B.R. 618 (Bankr. S.D. Ohio 1980).

withholding exemptions during the year in which the bankruptcy petition was filed. The bankruptcy court may be inclined to take this position, especially if the tax refund is due to tax deposits made by the debtor prior to the filing of the bankruptcy petition. In a memorandum to district counsel, Michael R. Arner, senior technician reviewer, branch 1 (general litigation), required the IRS to turn over part of a debtor's tax refund to a bankruptcy trustee, even though the debtor's stipulation with the bankruptcy trustee didn't include the IRS. In the memorandum, it was noted that the debtor did not have the right to make an election regarding the tax refund because it belonged to the estate.[162]

In *In re Barowsky*,[163] Todd Allen Barowsky and Kody Sirentha Barowsky filed a joint chapter 7 bankruptcy petition on July 24, 1987. On December 3, 1987, the bankruptcy court discharged the debtors upon a stipulation from the trustee that it was a no-asset estate. In early 1988, the Barowskys filed their federal income tax returns for the calendar year 1987. The Barowskys were entitled to a refund of $1,092.74. The trustee claimed that the portion of the refund attributable to the prepetition part of the Barowskys' tax year belonged to the estate. The Barowskys claimed that the refund did not constitute property of their estate and that, therefore, they were entitled to the entire refund. The Tenth Circuit held that the taxes should be prorated as suggested by the trustee.

The court relied on *Kokoszka v. Belford*.[164] In this case, the debtor filed for bankruptcy in January 1972; in February 1972, the debtor filed his income tax return for 1971, and later received a refund. The trustee claimed that the refund was property of the estate. The Supreme Court held that the refund was property of the estate. The Court held that the refund was "sufficiently rooted in the prebankruptcy past and so little entangled with the bankrupt's ability to make an unencumbered fresh start that it should be regarded as property. . . ."[165]

This case was decided under the Bankruptcy Act. In *Barowsky,* the court concluded that the concept of property under the Act also applied to the Bankruptcy Code. The Tenth Circuit noted that section 541 of the Bankruptcy Code adopted the Supreme Court's analysis of property as contained in *Segal.*

The court may also review estimated tax payments or overpayments in a prior year that are applied to next year's tax liability. In *In re Simmons*,[166] the trustee attempted to recover a 1987 overpayment of $7,799 that Simmons applied to his 1988 estimated tax on three bases:

1. The funds are property of the estate under section 542 of the Bankruptcy Code. The court noted that "[i]f any overpayment of income tax is, in accordance with section 6402(b), claimed as a credit against estimated tax for the succeeding taxable year, such amount shall be considered as a payment of the income tax for the succeeding taxable year (whether or not claimed as a credit in the return of estimated tax for such succeeding year), and no claim for refund of such overpayment shall be allowed for

[162] ILM 199941002; 1999 TNT 200-52; LTRServ, Oct. 25, 1999, p. 7727.
[163] 946 F.2d 1516 (10th Cir. 1991).
[164] 417 U.S. 642 (1974).
[165] *Id.* at 647 (quoting *Segal v. Rochelle*, *supra* note 160 at 380).
[166] 124 B.R. 606 (Bankr. M.D. Fla. 1991).

the taxable year in which the overpayment arises." The debtor's overpayment, at his election, then, according to the court, "became a payment of his 1988 estimated tax rather than an overpayment of his 1987 taxes." The court then concluded that the debtor "no longer had an overpayment for which he could file a claim for refund . . . [and] the debtor's prepetition estimated tax payment cannot be considered a legal or equitable interest of the debtor in property as of the commencement of the case, and such payment is not subject to turnover."

2. Avoid the transfer as a fraudulent transfer under the provisions of section 548 of the Bankruptcy Code. The trustee may avoid any transfer made or debt incurred on or within one year before the date of the filing of the petition, if the debtor (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud or (2) received less than a reasonably equivalent value in exchange for such transfer or obligation. The court concluded that the evidence did not prove any actual intent on behalf of the debtor to hinder, delay, or defraud his creditors by his overpayment of his taxes. The court also noted that the debtor received a reasonably equivalent value in exchange for his early payment of taxes, that is, a corresponding dollar-for-dollar reduction in his tax obligation.
3. Unauthorized postpetition transfer under section 549 of the Bankruptcy Code. Because the transfer was made prior to the filing of the bankruptcy petition, the court noted that the plaintiff had failed to carry his burden of proof to sustain a cause of action pursuant to section 549.

In *In re Weir III,*[167] the trustee also claimed that an estimated payment was a preference under section 547(b) of the Bankruptcy Code. The court concluded that the estimated payment made before the bankruptcy petition was filed was not a preference because the debtor's tax was not due until April 15, even though the debtor was required to make estimated payments.

In a third case,[168] the court did allow the recovery of part of a prior year refund that was credited to the next year's estimated payment. The court concluded that since the amount of the debtor's prepayment over and above taxes actually owed on the date he filed his bankruptcy petition was property of the estate, it should not have been credited to the debtor's account. Since what was done was merely as a bookkeeping entry, "the IRS will merely be directed to reverse the entry and pay the $3,257.35 to the Trustee." In this case, the court suggested that the way to determine the amount of refund due to an estate is to compare the estimated tax payments, withholdings, and so on, that have been applied to the current year with the tax liability that would arise from the earnings to the date the petition is filed. Thus, in cases where there are refunds, the *Lavelle* decision suggests that this type of adjustment will achieve the same result as if the debtor elects the short tax year under I.R.C. section 1398(d)(2). Considerable conflict still exists as to how to handle these estimated tax payments, withholdings, and so on, when the debtor does not elect the short tax year.

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[167] 1990 Bankr. LEXIS 778: 90-1 USTC (CCH) 50,229 (Bankr. D. Kan. 1990).
[168] *In re Lavelle*, 1991 Bankr. LEXIS 604 (Bankr. N.D. Cal. Apr. 17, 1991).

In *In re David Browning Canon,*[169] the trustee attempted to recover an overpayment of $14,900 in federal income taxes that the debtor and his wife elected to have credited to their estimated tax liability for the year in which the taxpayer filed a chapter 7 petition. The trustee demanded that the IRS turn over the check to the bankruptcy estate. The IRS notified the trustee that the return was being examined and if there was any tax refund it would be sent to the trustee. When the IRS completed the examination (including the year the petition was filed), it resulted in a tax refund of $14,900 which was mailed to Canon.

Pursuant to the U.S. Supreme Court's ruling in *Segal v. Rochelle,*[170] the court held that the overpayment of $14,900 from excessive withholding during the 1987 tax year which the Canons elected to apply to their 1988 estimated tax liability and which was subsequently refunded is property of the debtor's estate pursuant to section 541(a) of the Bankruptcy Code. The court found that the IRS was obligated to deliver the refund from the $14,900 overpayment to the trustee pursuant to section 542(a) of the Bankruptcy Code. The court's decision was without prejudice to the right of the IRS to pursue any proper collection remedies against the Canons to recover the $14,900 it improperly distributed.

In *In re Halle,*[171] the taxpayer made estimated deposits for taxes of $73,500 with the IRS six weeks before the petition was filed in October 1987. All of these taxes, except $37, were subsequently needed to cover the taxes for 1987. The bankruptcy court determined that the trustee was entitled only to the amount of estimated payments that were not needed. Because neither the IRS nor the debtor elected to raise the issue of allocating the payments, the court ruled against this. The court noted:

> [T]he previous order entered in this case left open the prospect of apportioning the estimated tax funds by requiring the IRS to turn over any estimated taxes in the IRS's possession which exceeded the statutory amount of estimated taxes due at the petition date. The Trustee and the IRS, however, both argued against apportioning at the hearing held in this matter. Hence, neither party presented evidence on the proper method of apportionment that this Court should use. The Court, therefore, will not allow the Trustee to receive any portion of the estimated tax deposits beyond the $37.00 remitted by the IRS to the Debtor, because the Trustee failed to meet its burden on this matter.

In *In re Nussbaum*[172] the debtor, as a debtor-in-possession, made a postpetition payment for all of his individual federal income tax liability for the year in which he filed his chapter 11 petition. However, the taxpayer did not elect under section 1398(d)(2)(A) to bifurcate that tax year prepetition and postpetition. A trustee subsequently appointed, brought action to recover the tax payment. Because the debtor did not make the short-year election to bifurcate that tax year, the trustee could recover the tax payment made from estate property because the debtor's tax liability was his personal, postpetition obligation and was not a claim against the bankruptcy estate.

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[169] 130 B.R. 748 (Bankr. N.D. Texas 1992).
[170] *Supra* note 160.
[171] 132 B.R. 186 (Bankr. D. Col. 1991).
[172] 210 B.R. 689 (Bankr. D. Maryland 1997).

(c) Income and Deductions

Income not reported in the estate and received by the debtor would normally be income that must be reported by the debtor on the individual tax return filed. Any income that is earned by the debtor from the estate would be reported as an expense of administration of the estate and would be picked up as income of the debtor on his individual tax return. Thus, in a bankruptcy proceeding, if the trustee pays a salary of $500 a week for the debtor to work for the estate during the bankruptcy proceeding, then the $500 a week would be an expense of administration and income to the debtor. This same provision would apply if the debtor was a debtor-in-possession and the court had authorized payment of this salary to him or her out of the estate. In some cases, the bankruptcy court may approve a disbursement for the individual for monthly living expenses. It would appear that the estate would deduct these disbursements on its return and the individual would report them as income (see § 4.3(e)).

Any deductions that are not allowed by the estate would be allowed by the individual (see § 4.3(e)).

(d) Attribute Carryover to Debtor

Upon termination of the estate in a chapter 7 or chapter 11 case, the debtor succeeds to (inherits) and takes into account the following tax attributes:

1. Net operating loss carryovers under I.R.C. section 172;
2. Charitable contribution carryovers under I.R.C. section 170(d)(1);
3. Tax benefit treatment for any amount subject to the I.R.C. section 111 tax benefit rule related to bad debts, prior taxes, and delinquency amounts;
4. Credit carryovers and all other items that, but for commencement of the case, are required to be taken into account with respect to any credit;
5. Capital loss carryovers under I.R.C. section 1212;
6. The estate's basis, holding period, and character of any asset acquired (other than by sale or exchange) from the estate;
7. Other tax attributes to the extent provided by the Treasury Regulations.[173]

Treas. Reg. sections 1.1398-1 and -2 provide that the individual debtor succeeds to the unsecured passive activity losses and credits under I.R.C. section 469 and to the unused losses from at-risk activities under I.R.C. section 465 remaining at the termination of the bankruptcy estate.

Treas. Reg section 1.1398-3 provides that the individual debtor succeeds to the exclusion from income the gain on the sale of a residence under section 121.

I.R.C. section 1398 does not address the issue of what date to use when the attributes are transferred back to the individual. It appears that the final tax return of the estate ends on the date the estate terminates and that the attributes are transferred to the individual as of that date. In a chapter 11 case, this date

[173] I.R.C. § 1398(i).

will, it seems, be the date the debt discharge is effective, and not the date when all provisions of the plan are carried out. In a chapter 7 case, it would also appear that the date to use is the effective date of the discharge. Most likely this "termination" date will be prior to the time the trustee will make a final report and file a final accounting of the administration of the estate as required by Bankruptcy Code section 704(9). In cases where the trustee has not timely "closed out the estate," the individual should not necessarily assume that the estate still exists for tax purposes.

(i) Method of Accounting

One of the items that is carried over to the estate, but is not listed among the attributes that are carried over to the debtor, is the method of accounting. Thus, it would appear that the debtor would not be required to use the method of accounting (cash, accrual, or otherwise) used by the estate.

(e) Loss Carryback

I.R.C. section 1398(j)(2)(B) provides the following:

> *Carrybacks from Debtor's Activities*—The debtor may not carry back to a taxable year before the debtor's taxable year in which the case commences any carryback from a taxable year ending after the case commences.

Thus, an individual incurring a net operating loss cannot carry back these losses to the year that preceded the year in which the chapter 7 or chapter 11 case was commenced. The term *carryback* would include not only net operating losses but also the other credit carried over from the estate. This provision would also prohibit the debtor from carrying back any subsequent net operating losses after the case closes to prepetition bankruptcy years. Even though it may appear that there is no justification for this provision, Klee suggests that there are very important reasons why the debtor would not want to carry back the loss even if he were allowed to do so. The main reason is that any benefit gained by a carryback belongs to the estate. If the estate is reopened, it will be administered for the benefit of the creditors. On the loss that is carried back, the creditors would reap the benefit rather than the debtor. If the losses were carried forward, then they would be to the benefit of the debtor and not the creditors.[174]

Additionally, it would appear that a debtor could not carry back to a postpetition year a net operating loss that the debtor succeeds to upon termination of the estate, where income was reported to obtain a refund. For example, assume a petition was filed on August 1, 20X2, and the estate was terminated on December 31, 20X4. Upon termination of the estate, the debtor could not carry back the net operating loss that the debtor succeeded to from the estate in 20X4 to receive a refund of taxes the individual paid in 20X3.

In a Private Letter Ruling,[175] the IRS looked at two key issues dealing with the carryback of the NOL of an estate and reached the following conclusions:

[174] Klee, *supra* note 71, at § 57.09[5].
[175] Private Letter Ruling 8932002, April 19, 1989.

1. I.R.C. section 1398(j)(2) allows an alternative tax net operating loss (ATNOL) of a bankruptcy estate to be carried back to a taxable year of the debtor that corresponds to a carryback year of the estate for such loss and is prior to the estate's first taxable year.
2. Neither an NOL nor an ATNOL of a bankruptcy estate is allowed as a deduction to the debtor for any taxable year that corresponds to a taxable year of the estate.

The IRS noted:

> [B]ecause an NOL of a bankruptcy estate which is carried back to an individual debtor's prior taxable year is allowable as an NOL deduction to the debtor under section 172 of the Code, such amount must also be included in computing the alternative tax net operating loss (ATNOL) deduction of the debtor for such carryback year under section 55(d). Thus, section 1398(j)(2) allows the ATNOL of a bankruptcy estate to be carried back to a taxable year of the individual debtor which is prior to the first taxable year of the estate in the same manner that a regular tax NOL of the estate is allowed as a carryback in a prior taxable year of the debtor.

I.R.C. section 1398(i) provides that, in the case of a termination of the bankruptcy estate, the individual debtor shall succeed to and take into account certain tax attributes of the estate, including NOL carryovers. Thus, at the termination of the estate, I.R.C. section 1398(i) would allow any carryover NOL of the estate to be allowed as a deduction by the debtor.

Neither I.R.C. section 1398(i) nor the legislative history to the Bankruptcy Tax Act of 1980 prohibits a debtor from carrying back an NOL of an estate to a debtor's taxable year that is prior to the termination of the estate. The IRS concluded, however, that to allow such a carryback would be inconsistent with the legislative intent of I.R.C. section 1398 to treat the estate and debtor as separate taxable entities. The IRS noted that allowing the debtor to carry back the estate's NOL would, with regard to the NOL deduction, effectively combine the estate and the debtor into a single taxpayer for the carryback year. There is nothing in I.R.C. section 1398 or the legislative history that suggests this result was intended. In the opinion of the IRS, NOL carryover to which a debtor succeeds on termination of a chapter 7 or chapter 11 case cannot be carried back and deducted by the debtor for a taxable year that corresponds to a taxable year of the estate.

(f) Automatic Stay

Section 362(a)(8) of the Bankruptcy Code provides that the filing of a stay operates as a stay against "the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor." Considerable uncertainty exists as to the impact that this provision might have on a debtor that files a chapter 7 or chapter 11 petition and incurs tax obligations separate from those of the bankruptcy estate resulting from income earned in the same taxable year but prior to the filing of a petition in a case where the election is not made to file a short tax return, or in subsequent taxable years of the individual debtor. Because these taxes are not subject to discharge and are not a liability of the bankruptcy estate, it might be concluded that the automatic stay is not

applicable. In fact, for claims other than tax claims, there is no stay regarding actions that may be brought against the individual separate from the bankruptcy estate.[176]

In *Halpern v. Commissioner*,[177] the court noted that the automatic stay under section 362(a) of the Bankruptcy Code generally operates to bar actions against or concerning the debtor or property of the debtor if the actions could have been brought before the bankruptcy petition was filed or if the actions represent efforts to collect on claims arising before the commencement of the bankruptcy case. Taxes falling under this general observation would be postpetition taxes. Under section 362(c)(1) of the Bankruptcy Code, the automatic stay also prohibits acts against property of the estate regardless of whether the claim may be characterized as prepetition or postpetition.[178]

Unless relief from the automatic stay is granted by the bankruptcy court under section 362(d) of the Bankruptcy Code, the automatic stay generally remains in effect until the earliest of the closing of the case, the dismissal of the case, or the grant or denial of a discharge.[179]

In *Halpern v. Commissioner*, the court examined the issue as to whether the automatic stay applies to collection by the IRS of post-petition tax claims by the individual taxpayer.

The Tax Court noted that section 362(a)(8) of the Bankruptcy Code, by its terms, expressly bars the commencement or continuation of a proceeding before the Tax Court concerning the debtor, and that the codification of this provision clarifies that the Tax Court should "no longer exercise wholly concurrent jurisdiction with the bankruptcy court with respect to the resolution of tax issues." The court then concluded that the automatic stay bars actions against the debtor in the Tax Court regardless of whether the underlying deficiency may be characterized as arising prepetition or postpetition. In reaching this conclusion, the Tax Court realized that the IRS is in a less advantageous position than that enjoyed by private creditors. The court noted, however, that the IRS is not without a remedy. If the IRS believes there is cause for the removal of the stay, it may seek relief from the bankruptcy court. While not addressed by the Tax Court, it would appear that the IRS would request the removal of the stay for the Tax Court to determine the tax liability, because it is doubtful that the bankruptcy court would have the authority to rule on the claim separate from that of the estate. In *In re Mirman*,[180] the bankruptcy court noted that it generally lacks jurisdiction over postpetition tax liabilities.

There are at least two situations where the bankruptcy court might determine the consequence of tax obligations that might be attributable to the debtor. Where taxes were earned during the taxable year prior to the filing of the petition, the bankruptcy court, in *Mirman*, concluded that it has jurisdiction to

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[176] *See In re Petruccelli*, 113 B.R. 5, 6 (Bankr. S.D. Cal. 1990); *In re Harvey*, 88 B.R. 860, 862 (Bankr. N.D. Ill. 1988); *In re York*, 13 B.R. 757, 758 (Bankr. D. Me. 1981).
[177] 96 T.C. 895 (1991).
[178] *In re Petruccelli*, 113 B.R. 5, 6 (Bankr. S.D. Cal. 1990).
[179] *Smith v. Commissioner*, 96 T.C. 10, 14; *Neilson v. Commissioner*, 94 T.C. 1, 8 (1991).
[180] 98 B.R. 742, 745 (Bankr. E.D. Va. 1989).

determine the tax if an election is made to file a short tax return. Additionally, postpetition tax liabilities may be pursued in chapter 13 bankruptcy proceedings if provided for in the plan and if the IRS files a proof of claim.[181]

§ 4.5 SUMMARY

There are several issues that the trustee or debtor-in-possession should consider in tax planning for the estate or for the individual debtor. These issues are:

1. The trustee or debtor-in-possession should select the year-end for the estate that will allow the income to be spread over the largest number of taxable years or that places the income from debt discharge in the years that will be most beneficial to the estate.
2. There exists some uncertainty as to how the administrative expenses are classified on the 1040 return that is filed with the 1041, Estate Return. Items that are normally deducted, such as expenses allowed on schedules C, E, or F, should be handled in the normal manner. Administrative expenses that would not be allowed except for the fact that title 11 petition was filed could be considered deductions for adjusted gross income or deductions from adjusted gross income in the form of itemized deductions. With the two percent limitations on miscellaneous itemized deductions added by the Tax Reform Act of 1986, the amount of administrative expenses allowed could be reduced significantly if these costs are listed as itemized deductions. Administrative costs are not included in the list of exceptions to the two percent limitation. Since section 1398(h) provides that these costs are deductible and, if not used, can be carried back three or forwarded seven years, it would appear that they should be considered deductions for adjusted gross income. These administrative expenses could be listed as a negative value in the other income category on the front of form 1040. However, some representatives from the Service required these times to be listed on Schedule A of 1040.
3. In cases in which the debtor is insolvent, the debtor may attempt to file a chapter 11 plan, transfer the property to the creditor, and then convert the petition to a chapter 7. The court may dismiss the petition on the basis that it was filed in bad faith. The debtor should be aware that the IRS may in some cases object to this process and ask the court to dismiss the petition. However, in many cases it is worth taking the risk. If the petition is dismissed, the individual will be personally liable for any taxes that might be due on the transfer. However, if the property was recourse, part of the gain may be income from debt discharge. If, however, the individual had filed a chapter 7 petition and the trustee abandoned the property, all of the gain may be gain on transfer rather than only part of the gain being taxed as gain on transfer.
4. The debtor should take the action necessary to see that the tax returns are filed by the trustee, if appointed, and that they are correctly filed to pre-

[181] *See* 11 U.S.C. § 1305(a)(1), (b); *In re Hester*, 63 B.R. 607, 609 (Bankr. E.D. Tenn. 1986).

serve any tax attributes that should be returned to the debtor when the estate is terminated.

5. In most cases it would be presumed that the debtor would make the short tax year election if income was earned as of the date the petition was filed and would not make the election if there was a loss for this time period. In making a decision as to whether a short tax return should be filed, the debtor will need to consider the fact that the basis of assets is transferred over to the estate as of the first day of the taxable year in which the petition was filed. Thus, if the short tax return is not filed, the individual, it appears, would not have any depreciation deduction for the assets that were transferred to the estate. To obtain the depreciation deduction, the individual would have to file a short tax return.
6. Another factor to consider in electing whether to file a short tax return is the method by which tax liability is determined. If a short tax return is filed, any litigation associated with the taxes due under that return would be handled by the bankruptcy court. However, if the debtor elected not to file a short tax return, any dispute concerning that return would be handled by the Tax Court. In filing a return for either short period—the one up to the date the bankruptcy petition was filed or the period from the date the bankruptcy petition was filed to the end of the tax year—the debtor must annualize income and make the other adjustments that are required under section 443 of the I.R.C.

CHAPTER FIVE

Corporate Reorganizations

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§ 5.1 INTRODUCTION

(a) Importance of Reorganization Provisions in Bankruptcy and Insolvency Restructuring

As noted in § 1.1, it is not uncommon for a corporation in bankruptcy to realize taxable income during the administration of a bankruptcy proceeding. An insolvent corporation is also likely to have significant historical losses, which might, under the proper circumstances, be available to offset both current and future taxable income. Preservation of historical losses is complicated if a corporation's debt restructuring involves transactions with other corporations. The particular limitations the I.R.C. places on the use of historical losses are discussed in Chapter 6. To understand these limitations, however, it is necessary to have an understanding of the tax treatment of the various forms of corporate reorganization. That is the function of this chapter.

(b) Exception to the General Rule of Taxation

A reorganization is an exception to the general rule that, upon the exchange of property, any gain or loss realized will be recognized. The very purpose of the reorganization provisions of the I.R.C. is to except from the general rule the specific exchanges described in those provisions.[1] Thus, if a transaction qualifies as a reorganization, gain or loss realized in the transaction will, in general, not be recognized at either the corporate[2] or shareholder[3] level. The gain or loss, however,

[1] Treas. Reg. § 1.368-1(b).
[2] I.R.C. § 361.
[3] I.R.C. § 354.

does not disappear; rather, it is preserved in the tax basis of the property received in the reorganization, which generally will be the same as the basis of the property exchanged.[4] The nature of the gain—long-term or short-term—is also preserved: the holding period of the property exchanged in the reorganization is "tacked on" to the property received.[5] The rationale for the exception to the general gain/loss recognition provisions is that reorganization constitutes a mere readjustment of a continuing interest in property under modified corporate form.

(c) Overview of Section 368

I.R.C. section 368 defines the transactions that qualify as reorganizations and excludes all others. In general, I.R.C. section 368 describes three types of transactions: (1) asset acquisitions, including "A" mergers, forward triangular mergers, "C," "D," and "G" reorganizations; (2) stock acquisitions, including "B" reorganizations and reverse triangular mergers; and (3) single entity reorganizations, including "E" and "F" reorganizations. Divisive reorganizations that meet the requirements of I.R.C. section 355 will be tax-free and may also qualify as "D" or "G" reorganizations.

§ 5.2 ELEMENTS COMMON TO MANY REORGANIZATION PROVISIONS

(a) Overview

All the reorganization provisions require a business purpose for undertaking the transaction. Reorganizations also generally require continuity of business enterprise and continuity of interest.[6] These requirements have stood the test of time in the courts. They have, however, significantly evolved through the regulatory process. The tax treatment that follows from compliance with the reorganization provisions is essentially the same for each reorganization. Therefore, instead of considering many of the judicial and statutory provisions applicable to each reorganization separately, those precepts applicable to two or more reorganizations will be discussed below. Although the "solely for voting stock" and "substantially all" requirements are common to a number of reorganizations, they will be covered separately with each reorganization.

(b) Business Purpose

The Treasury Regulations provide that a reorganization (1) must be undertaken for reasons that are "germane to the continuance of the business of a corporation"[7] or (2) must be "required by business exigencies."[8] Thus, a transaction that meets

[4] I.R.C. §§ 362(b) (corporations); 358 (shareholders).

[5] I.R.C. §§ 1223(2) (corporations); 1223(1) (shareholders).

[6] It is generally accepted that "E" reorganizations do not require continuity of business enterprise (discussed in § 5.2(c)) or continuity of interest (discussed in § 5.2(d)).

[7] Treas. Reg. § 1.368-2(g).

[8] Treas. Reg. § 1.368-1(b).

the literal requirements of a reorganization under I.R.C. section 368 may fail to qualify due to a lack of a business purpose if it is undertaken purely for tax avoidance or if it is a "sham." To withstand a sham transaction attack, there must be a legitimate business purpose for the transaction. Some commonly accepted business purposes include: to achieve operating efficiencies, to penetrate new markets, or to diversify into new product lines.

(c) Continuity of Business Enterprise

A reorganization must result in a continuity of business enterprise (COBE). Prior to 1980, all that was necessary to satisfy COBE was that the acquiring corporation be engaged in business activity.[9] In 1980, an initial set of Treasury Regulations were promulgated that required the acquiring corporation to either continue the historical trade or business of the target corporation (business continuity) or use a significant portion of the target corporation's assets in its trade or business (asset continuity).[10] A set of Treasury Regulations that altered the COBE requirements was issued in 1998.[11] These COBE regulations maintained the business continuity and asset continuity concepts of the 1980 Treasury Regulations. That is, to satisfy COBE, the acquiring corporation must either continue a significant historical business of the target corporation or use a significant portion of the target corporation's historical business assets in a business.[12] Examples in the regulations indicate that one-third will be "significant" for either purpose.[13] COBE is measured only with respect to the assets or activities of the target corporation and is not based on the acquiring corporation's historical activities.[14]

COBE is generally not violated when the stock or assets received in the reorganization are transferred or "dropped" to a controlled corporation.[15] I.R.C. section 368(a)(2)(C) only allows transfers to controlled subsidiaries following "A,"

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[9] *Appeal of Laure*, 653 F.2d 253 (6th Cir. 1981); *United States v. Adkins-Phelps, Inc.*, 400 F.2d 737 (8th Cir. 1968); *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955); *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961).

[10] T.D. 7745, 45 Fed. Reg. 86433 (Dec. 31, 1980).

[11] T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998). The final regulations are generally effective for transactions occurring after January 28, 1998.

[12] Treas. Reg. § 1.368-1(d)(1).

[13] Treas. Reg. § 1.368-1(d)(5), Ex. 1 (business continuity), Ex. 2, Ex. 10 (asset continuity). This one-third concept also existed in the 1980 regulations.

[14] *See, e.g.*, Rev. Rul. 87-76, 1987-2 C.B. 84 (COBE violation when a target corporation engaged in historical business of trading in stocks and bonds disposes of that business (at the behest of the acquiring corporation) and now trades in municipal bonds); Rev. Rul. 85-197, 1985-2 C.B. 120 (COBE satisfied when a holding company merges downstream into its subsidiary because the holding company is considered engaged in the business of its operating subsidiary); Rev. Rul. 81-25, 1981-1 C.B. 132 (COBE violation when target corporation engaged in manufacturing sells all its assets to an unrelated party for cash and uses the cash to engage in a business unrelated to manufacturing).

[15] "Control" for this purpose is defined as stock possessing 80 percent of voting power and 80 percent of the number of shares of nonvoting stock on a class-by-class basis. I.R.C. § 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

"B," "C," or "G" reorganizations. In Rev. Rul. 2002-85,[16] the IRS added "D" reorganizations to that list. The IRS reached this conclusion despite the fact that the permissive language of I.R.C. section 368(a)(2)(C) does not include "D" reorganizations. Nevertheless, consistent with the ruling and the regulations, successive drops down a chain of controlled corporations within a "qualified group" (discussed below) or to a partnership would also be permitted after a "D" reorganization. In addition, it may be argued that similar transfers should be permitted after an "F" reorganization.[17] Proposed regulations would adopt the position that the COBE requirement is not applicable to "E" and "F" reorganization.[18]

The COBE regulations take this concept several steps further by permitting the acquiring corporation to transfer, or to cause other controlled corporations to transfer, the target corporation's assets or stock to and among members of a "qualified group" without violating COBE.[19] The regulations accomplish this by treating the acquiring corporation[20] as holding all the businesses and assets held by the members of the "qualified group." A qualified group is one or more chains of corporations connected through stock ownership with the acquiring corporation.[21]

The application of the COBE regulations must often be applied hand-in-hand with Treas. Reg. section 1.368-2(k), which extends I.R.C. section 368(a)(2)(C) by permitting a transfer or successive transfers following certain reorganizations, provided each transferor controls each transferee within the meaning of I.R.C. section 368(c).

The COBE regulations restrict drop-downs of assets or stock to the genus of property acquired in the reorganization.[22] Thus, in an asset reorganization, assets can be dropped; in a stock reorganization, stock can be dropped. For this purpose, reverse triangular mergers under I.R.C. section 368(a)(2)(E) are treated as both stock and asset reorganizations, thereby permitting the subsequent

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[16] 2002-2 C.B. 986.

[17] *See* Rev. Rul. 96-29, 1996-1 C.B. 50, discussed at § 5.6(b), which could be interpreted to stand for the proposition that an "F" is analyzed separately from the asset drop. *See also*, P.L.R. 200215027 (Jan. 10, 2002) (merger qualified as an "F" reorganization, even though after the merger assets that had been transferred in the merger were contributed to a lower-tier controlled corporation that was spun off to shareholders).

[18] Prop. Reg. § 1.368-2(m); REG-106889-04 (Aug. 11, 2004).

[19] Treas. Reg. § 1.368-1(d)(4).

[20] For the purposes of simplicity, the term "acquiring corporation" is used in this book. The regulations use the term "issuing corporation" to refer to the corporation in control of the acquiring corporation (when the stock of such corporation is used as consideration in a triangular reorganization) and the acquiring corporation (when the stock of the acquiring corporation is used as consideration in the reorganization).

[21] The acquiring corporation must own directly stock meeting the requirements of I.R.C. section 368(c) (80 percent voting power and 80 percent total number of shares of each nonvoting class of stock) in at least one of the corporations, and stock meeting the requirements of I.R.C. section 368(c) in each of the corporations must be owned directly by one of the other corporations. Treas. Reg. § 1.368-1(d)(4)(ii).

[22] Treas. Reg. §§ 1.368-2(f); 1.368-2(k). The proposed regulations had not imposed this restriction.

drop-down of either stock or assets.[23] The IRS has extended this treatment to forward triangular mergers.[24]

One of the major relaxations of the COBE doctrine introduced by the COBE regulations involves the use of partnerships. In general, for purposes of evaluating asset continuity, the acquiring corporation is treated as owning the assets of the partnership in accordance with the qualified group's aggregate partner interest in the partnership.[25] For purposes of evaluating business continuity, the acquiring corporation will be treated as conducting a business of the partnership if:

- One or more members of the qualified group own in the aggregate an interest in the partnership representing a significant interest (at least one-third) in that partnership business,[26] or
- One or more members of the qualified group have active and substantial management functions as a partner with respect to that partnership business, and the qualified group has a requisite interest in the partnership (examples indicate that a 1 percent interest will not satisfy the requisite interest component and that a 20 percent interest will).[27]

Once the partnership assets and partnership business are attributed to the acquiring corporation in accordance with the rules outlined above, COBE is tested under the general requirement that the acquiring corporation either continue the target corporation's historical business or use a significant portion of the target corporation's historical business assets in a business.

The COBE regulations caution, however, that the Step Transaction Doctrine will apply in determining whether the transaction is otherwise a tax-free reorganization.[28] Thus, a transfer of the target corporation's stock to a partnership after a "B" reorganization may satisfy COBE (good news), but nevertheless fail to satisfy the more basic I.R.C. section 368(a)(1)(B) requirement of "control immediately after" (bad news), rendering the putative reorganization taxable.[29] Notice the distinction between the transfer of the target corporation's stock after a stock reorganization to a partnership (not permitted) and a transfer of the target corporation's assets after an asset reorganization to a partnership (permitted). Implicit in the entire regulation is the fact that the transfer of *assets* to a *partnership* after an "A," "C," "D," or "G" reorganization is now permitted, even though no such transfer is described in I.R.C. section 368(a)(2)(C) and

[23] Treas. Reg. § 1.368-2(k)(2).
[24] Rev. Rul. 2001-24, 2001-1 C.B. 1290 (forward subsidiary merger will not be disqualified or recharacterized due to the parent's post-merger contribution of the acquiring stock to another wholly owned subsidiary).
[25] Treas. Reg. § 1.368-1(d)(4)(iii)(A).
[26] Treas. Reg. §§ 1.368-1(d)(4)(iii)(B)(1); 1.368-1(d)(5), Ex. 11.
[27] Treas. Reg. §§ 1.368-1(d)(4)(iii)(B)(2); 1.368-1(d)(5), Ex. 7, Ex. 8.
[28] Treas. Reg. § 1.368-1(a).
[29] Treas. Reg. § 1.368-2(k)(3), Ex. 3.

even though under the Step Transaction Doctrine, no such tolerance would be allowed. Similarly, it appears that such transfers to partnerships should be permitted in "D" and "F" reorganizations.[30]

(d) Continuity of Interest

There must be a continuity of interest (COI) in a reorganization. In general, this means that a substantial part of the value of the proprietary interest in the target corporation must be preserved in the reorganization. The proprietary interest in a target corporation is preserved if it is exchanged for a proprietary interest in the acquiring corporation or a corporation that is in control of the acquiring corporation in the case of a triangular reorganization.[31] Only stock ownership (either voting or nonvoting) can satisfy this test; cash, short-term notes, bonds, and options or warrants do not convey proprietary rights and will not, therefore, establish the needed COI.[32] This requirement is designed to distinguish a tax-free reorganization from a taxable sale.

The question of how much stock of the acquiring corporation must be received by the shareholders is not entirely settled. To obtain an advance ruling from the IRS, the taxpayer must represent for COI purposes that the stock of the acquiring corporation received by the shareholders of the target corporation has a fair market value equal to or greater than 50 percent of the fair market value of the target corporation's stock outstanding immediately prior to the transaction.[33] Despite the safe harbor rule, it is generally agreed that 38 percent is sufficient.[34]

Treasury Regulations issued in 1998 changed the playing field with regard to this requirement.[35] The most significant change resulting from the COI regulations is that a target corporation's shareholders who receive acquiring corporation stock in a reorganization may dispose of that stock (even as part of the overall plan of reorganization and pursuant to a binding agreement) without violating the COI requirement.[36] This was a liberalization of the test enunciated in prior case law, under which the shareholders of the target corporation were

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[30] *See supra*, notes 17 and 18 and accompanying text.

[31] Continuity-providing stock may be stock of the acquiring corporation or stock of the parent of the acquiring corporation, which is referred to in the regulations as stock in the "issuing corporation." Treas. Reg. § 1.368-1(b).

[32] *See* Treas. Reg. §§ 1.368-1(e)(1), -1(b); *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Courtland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932).

[33] Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.02, *amplified by* Rev. Proc. 86-42, 1986-2 C.B. 722 and Rev. Proc. 89-50, 1989-2 C.B. 631.

[34] *See John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

[35] Temporary and proposed regulations governing additional COI issues were also issued on January 23, 1998. T.D. 8761, 63 Fed. Reg. 4183 (Jan. 28, 1998). These temporary and proposed regulations have the same effective date as do the final regulations.

[36] Treas. Reg. § 1.368-1(e)(6), Ex. 1.

required to maintain stock ownership in the acquiring corporation.[37] The regulations generally changed the COI focus from the retention of an equity interest to an evaluation of the consideration issued in the reorganization. In addition, the COI regulations expanded proposed regulations by generally permitting pre-reorganization dispositions of target corporation stock.[38]

This permissive approach to dispositions of stock *in connection with* reorganizations is tempered by exceptions that focus on a target shareholder's receipt (or deemed receipt) of nonstock consideration, or "boot." Section 356 generally addresses the receipt of nonstock consideration, commonly referred to as boot, in a reorganization. Evaluation of the extent to which boot has been received requires a determination of whether a pre-reorganization distribution or redemption should be treated as boot in the reorganization or a separate transaction. Such determinations involve many unresolved issues. In general, COI will be impaired to the extent consideration received by a target shareholder prior to a reorganization (either in a redemption of target corporation stock or in a distribution with respect to target corporation stock) is treated as boot.[39] Also, COI will generally be impaired to the extent that, in connection with a reorganization, target stock is acquired for consideration other than stock of the acquiring corporation (i.e., boot in the reorganization) or to the extent the stock consideration is redeemed.[40]

Finally, COI will be impaired to the extent that, in connection with a reorganization, a party that is related to the acquiring corporation acquires with property other than stock of the acquiring corporation, stock of the target corporation or stock consideration that was furnished in exchange for stock of the target corporation.[41] In general, corporations in the same affiliated group as the acquiring corporation are considered related persons, and some corporations that are only

[37] Before regulations were issued in 1998, a post-reorganization disposition of stock, however, could undo an otherwise qualifying reorganization. The uncertainty this issue created was exacerbated by contradictory case law. *Compare McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982) (no COI when target corporation's shareholders received stock from the acquiring corporation and, pursuant to an overall plan, registered the stock with the SEC and disposed of it to third parties for cash), *with Penrod v. Commissioner*, 88 T.C. 1415 (1987) (COI satisfied under similar facts, where the sale of 90 percent of an acquiring corporation's stock within 8 months of the reorganization was held to be an independent step).

[38] Treas. Reg. §§ 1.368-1(e)(1)(i); 1.368-1(e)(6), Ex. 1. For pre-regulation case law addressing pre-reorganization COI *see J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995), in which the court found a tax-free reorganization by treating Seagram as a historical shareholder of Conoco, even though Seagram's interest in Conoco had been recently purchased in a failed takeover attempt. For a more extensive discussion of this development in the law of COI, see Bloom, Taxpayers Have More Flexibility in Reorganizations After *Seagram*—If it Survives, 82 *J. Tax'n* 334 (June 1995).

[39] Treas. Reg. § 1.368-1(e)(1)(ii). *See* Rev. Rul. 71-364, 1971-2 C.B. 182; Debra J. Bennett and Nelson F. Couch, "The Effect of Target Redemptions and Distributions on Continuity of Interest," 89 *Tax Notes* 1301 (Dec. 4, 2000).

[40] Treas. Reg. § 1.368-1(e)(l).

[41] Treas. Reg. § 1.368-1(e)(2).

related by 50 percent ownership are considered related persons.[42] This related party acquisition impairment to COI will not apply in two circumstances. First, if persons who were the direct or indirect owners of the target stock prior to the reorganization maintain a direct or indirect interest in the acquiring corporation, COI will be satisfied.[43] Second, if a reorganization occurs following a qualified stock purchase (QSP), COI will be satisfied despite the fact that 80 percent or more of the stock of a target has been purchased by a related corporation.[44]

The preamble to the COI regulations indicates that the IRS is continuing to study the role of the COI requirement in "D" reorganizations and I.R.C. section 355 transactions. Therefore, the COI regulations do not apply to "D" reorganizations or to I.R.C. section 355 transactions.[45]

A reorganization, then, is a transaction described in I.R.C. section 368, undertaken for a bona fide business purpose that satisfies both COBE and COI.[46]

(e) Control

Control is another concept that is important to the reorganization provisions. For example, an acquiring corporation must obtain "control" of the target corporation in a stock-for-stock "B" reorganization. In addition, where the reorganization provisions permit stock of the acquiring corporation's parent (rather than the acquiring corporation itself) to be used to effect the reorganization, the parent must "control" the acquiring corporation. Finally, after certain reorganizations, assets may be transferred to a corporation "controlled" by the acquiring corporation. Control for all these purposes is defined as 80 percent of the voting

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[42] Treas. Reg. § 1.368-1(e)(3).

[43] Treas. Reg. § 1.368-1(e)(2). Thus a sale, transfer, or distribution of stock of the acquiring corporation after a reorganization between two members of an affiliated group will not have a negative impact on COI, because the ultimate indirect owners of the stock remain the same. The regulations are consistent with the prior position of the IRS. *See, e.g.,* Rev. Rul. 84-30, 1984-1 C.B. 114 (stock received by target corporation can be distributed to target's shareholders, who in turn can distribute the stock up the chain without violating COI).

[44] *See* Treas. Reg. §§ 1.338-3(d); 1.368-1(e)(6), Ex. 4. See discussion of I.R.C. section 338 in Chapter 7. For purposes of a broad overview, a QSP is generally defined in I.R.C. section 338(d)(3) as a purchase or series of purchases of the stock of a target corporation by an acquiring corporation over a 12-month period that constitutes 80 percent or more of the stock of the target corporation as defined in I.R.C. section 1504(a)(2). This exception may lead to strange results. For example, assume that parent corporation (P) owns 100 percent of subsidiary (S). P purchases 100 percent of the stock of a target corporation (T) for cash and S then merges into T. COI would be satisfied because the merger followed a QSP. If P had purchased 75 percent (rather than 100 percent) of the T stock for cash, the purchase would not be a QSP and COI would not be satisfied. I.R.C. section 338 also raises other interesting COI issues. *See, e.g.,* Rev. Rul. 2001-46, 2001-2 C.B. 321; Rev. Rul. 90-95, 1990-2 C.B. 67; T.D. 9071, 68 Fed. Reg. 40766 (July 9, 2003).

[45] T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998) (preamble).

[46] Note that recently issued proposed regulations would adopt the position that COI is not required in an "E" and "F" reorganization. Prop. Reg. § § 1.368-1(b), 1.368-2(m), REG-106889-04 (Aug. 11, 2004).

stock and 80 percent of each class of nonvoting stock.[47] Unlike the definition of control in the context of the liquidation of a subsidiary into its parent,[48] or the determination of entities entitled to file consolidated returns,[49] the control definition discussed above is not based on value. A corporation is permitted to file a consolidated return with a subsidiary if it owns 80 percent of the voting stock and 80 percent of the value of the stock of the subsidiary, notwithstanding its failure to own any stock of a class of nonvoting preferred.[50] However, the failure to own at least 80 percent of a class of nonvoting preferred stock will preclude satisfying the definition of control for purposes of the reorganization requirements discussed above. Furthermore, the control must be direct, not through subsidiaries.[51]

Control tests are not always mechanically applied. In *Alumax v. Commissioner*,[52] the Eleventh Circuit Court of Appeals rejected a perfunctory application of the I.R.C. section 1504(a)(2) test, because restrictions on the ability of directors to carry out all of their management functions diluted the effectiveness of both the directors' vote and the shareholders' vote.[53] Although *Alumax* involved the taxpayers' ability to file a consolidated return, its principles should be equally applicable to the I.R.C. section 368(c) control requirement in "B" and "D" reorganizations.

(f) Contingent and Escrowed Shares

Tax-free reorganizations generally require the issuance of stock. This requirement raises questions about the proper treatment of transactions in which stock will or may be issued after the reorganization. Generally, debt, warrants, or options, which either will or may result in future stock issuances, do not count as stock currently issued for purposes of satisfying COI.[54] The IRS has, however, provided guidelines addressing the issuance of contingent shares or escrowed shares in tax-free reorganizations in Rev. Proc 84-42.[55] Shares that are unissued, but subject to issuance in the future, are designated "contingent shares." The guidelines for contingent stock are generally as follows:

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[47] I.R.C. § 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

[48] I.R.C. § 332.

[49] I.R.C. § 1504(a)(2).

[50] *See* I.R.C. § 1504(a)(4) (excluding certain preferred stock – so-called vanilla preferred—from the definition of "stock" for purposes of I.R.C. section 1504(a)).

[51] Rev. Rul. 56-613, 1956-2 C.B. 212.

[52] 165 F.3d 822 (11th Cir. 1999), *aff'g* 109 T.C. 133 (1997).

[53] *See also* T.A.M. 9452002 (Aug. 26, 1994) (taxpayer did not satisfy the control requirement, because the power of the board of directors was too restricted, even though it met the numerical 80-percent threshold).

[54] Treas. Reg. § 1.368-1(e). *See Bateman v. Commissioner*, 40 T.C. 108 (1963), *nonacq.*, 1965-2 C.B. 7.

[55] 1984-1 C.B. 521.

- All the stock will be issued within 5 years from the date of the reorganization;
- There is a valid business reason for not issuing all the stock immediately, such as difficulty in determining the value of one or both of the corporations involved in the transactions;
- The maximum number of shares which may be issued in the exchange is stated;
- At least 50 percent of the maximum number of shares of each class of stock which may be issued is issued in the initial transaction;
- The right to receive stock is either nonassignable by its terms or if evidenced by negotiable certificates then not readily marketable;
- Such right can give rise to the receipt only of additional stock of the corporation making the underlying distribution;
- Such stock issuance will not be triggered by an event the occurrence or nonoccurrence of which is within the control of shareholders;
- Such stock issuance will not be triggered by the payment of additional tax or reduction in tax paid as a result of an IRS audit; and
- The method for calculating the additional stock to be issued is objective and readily ascertainable.

Rev. Proc. 84-42 provides a similar set of guidelines with respect to stock or property issued in a reorganization that is put in escrow under an agreement that directs an escrow agent to either release the stock to the acquiring corporation's shareholders if certain conditions are satisfied or return the stock to the target corporation. The tax consequences resulting from the return of the escrowed shares will depend on the terms of the deal. If the number of shares that are returned was based on their initial negotiated value and the taxpayer had no right to substitute other property for the escrowed stock in the event of a repossession, then no gain or loss will be recognized to the beneficial owners.[56] If, however, the number of shares of escrowed stock returned is based upon the fair market value of the stock on the date of the return from escrow, then gain or loss will be realized to the beneficial owner in an amount equal to the difference between the fair market value and the basis of such stock at the time of the return.[57]

It appears that if the Rev. Proc. 84-42 guidelines are followed, COI will be satisfied.[58] To ensure that outcome, however, it may be prudent for the minimum percentage of stock consideration to total consideration (i.e., 38 percent

[56] *See* Rev. Rul. 76-42, 1976-1 C.B. 102; *see also* Rev. Rul. 76-334, 1976-2 C.B. 108 (escrow agreement separate from reorganization).

[57] Rev. Rul. 78-376, 1978-2 C.B. 149.

[58] The "solely for voting stock" requirement of "B" and "C" reorganizations should also be satisfied.

generally or 50 percent in the context of a private letter ruling)[59] to actually be issued and outstanding. It is also questionable whether, in light of the liberalization of the COI regulations discussed in § 5.2(d), the ability to assign or dispose of the rights to stock should continue to have any impact on reorganization qualification, unless of course the rights are sold back to the acquiring corporation or a related party.

(g) Tax Treatment: Operative Provisions

The language of I.R.C. section 368 does not provide for tax-free treatment; rather, it defines the types of reorganizations that qualify for tax-free treatment if the judicial and regulatory standards (i.e., business purpose, COI, COBE) are satisfied. Other provisions of the I.R.C. ("operative provisions") furnish the tax treatment for reorganizations. The tax consequences of a reorganization are *generally* as follows.[60] The target corporation will recognize no gain or loss on the transfer of its assets to the acquiring corporation.[61] Similarly, the target corporation will not recognize gain or loss on the distribution of acquiring stock or other assets (received in exchange for its assets) to its shareholders or creditors.[62] The acquiring corporation will recognize no gain or loss on its receipt of the assets of the target corporation, its basis in those assets will be the same as the basis the target corporation had in the assets, and the holding period of the assets will include the period during which the target corporation held the assets.[63] Similarly, the shareholders of the target corporation will recognize no gain or loss when they exchange their stock in the target corporation for stock in the acquiring corporation,[64] and such stock will generally have the same basis as the surrendered stock of the target corporation. The holding period of the stock will include the time during which they held the stock of the target corporation.[65]

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[59] *See supra* notes 33 and 34 and accompanying text.

[60] The purpose of this chapter is to give a general overview of the reorganization provisions. Although some exceptions to the general rules are mentioned, a discussion of every exception is beyond the scope of this book. In addition, other provisions, such as the consolidated return regulations, could have an impact on the tax consequences.

[61] *See* I.R.C. §§ 361(a); 357(a). *But see* I.R.C. §§ 361(b), 357(b), and 357(c), which may result in corporate level gain in a reorganization in the event that other property is used to acquire the target corporation assets and such property is not distributed pursuant to the plan of reorganization, liabilities of the target are assumed by the acquiring corporation for avoidance purpose, or the acquiring corporation assumes liabilities of the target in excess of target's basis in its assets. *See infra* § 5.4(a)(iv)(E).

[62] I.R.C. § 361(c).

[63] *See* I.R.C. §§ 1032; 362(b); 1223(2).

[64] In the context of a triangular reorganization, stock of a corporation in control of the acquiring corporation.

[65] *See* I.R.C. §§ 354; 358(a); 1223(1).

The same nonrecognition, substituted basis, and tacked holding period rules will apply to securities (generally long term debt[66]) of the acquiring corporation[67] received in exchange for target securities.

If a target corporation shareholder receives boot (property other than stock of the acquiring corporation or stock of the parent of the acquiring corporation in certain reorganizations), the shareholder may recognize gain or dividend income but not loss.[68] In addition, if the principal amount of securities received in a reorganization exceeds the principal amount of the target securities exchanged therefor, the fair market value of the excess principal is boot.[69]

Preferred stock did not constitute boot until the Taxpayer Relief Act of 1997 modified various incorporation and reorganization I.R.C. provisions to treat certain preferred stock ("nonqualified preferred stock") as boot.[70] With specified exceptions, nonqualified preferred stock is stock that is limited and preferred as to dividends, does not participate in corporate growth to any significant extent, and has a feature that would cause it to be redeemed within 20 years from the date of issuance.[71] In the context of a reorganization, nonqualified preferred stock received in exchange for stock (other than nonqualified preferred stock) is boot subject to gain recognition.[72]

The status of nonqualified preferred stock as boot is limited to gain recognition; nonqualified preferred stock is treated as stock for other purposes.

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[66] "Long term" is not defined. The conventional rule of thumb is that an average maturity date of less than 5 years is short term, more than 10 years is long term, and between 5 and 10 years is inconclusive. The maturity date is not the only factor that determines whether a security is long-term, however. *See* Boris I. Bittker and James S. Eustice, "Federal Income Taxation of Corporations and Shareholders" 12.41[3] (7th ed. 2002). In Revenue Ruling 2004-78, a security of a target corporation (issued with a 12-year term to maturity) was exchanged 10 years after its issuance for acquiring corporation debt (with the same maturity date, now two years later). Except for a change in the yield, this was a significant modification under the terms. The IRS ruled that the exchange will be treated as a security-for-security exchange that qualifies for non-recognition treatment. One interesting aspect of this ruling is that the acquiring security only had a two-year term to maturity when issued, to match the maturity date of the target security. Rev. Rul. 2004-78, 2004-31 I.R.B. 1. This ruling may not be a taxpayer-favorable rule in all situations. For example, non-recognition treatment would prevent the recognition of losses as well as gains.

[67] In the context of a triangular reorganization, stock of a corporation in control of the acquiring corporation.

[68] *See* I.R.C. § 356.

[69] I.R.C. § 356(d). In addition, the I.R.C. section 354 nonrecognition provisions do not apply to stock, securities, or other property that are attributable to interest that has accrued on such securities on or after the beginning of the holder's holding period.

[70] *See* I.R.C. § 354(a)(2)(B); Treas. Reg. § 1.356-7.

[71] *See* I.R.C. §§ 354(a)(2)(C)(i); 351(g)(2).

[72] I.R.C. § 354(a)(2)(B). An exception to the preferred-stock-as-boot rule is provided for the recapitalization of a family-owned corporation, defined as a corporation with at least 50 percent of the total combined voting power of all classes of stock entitled to vote and at least 50 percent of all other classes of stock owned by members of the same family for five years before and three years after the recapitalization. "Members of the same family" include children, parents, grandparents, brothers, sisters, and spouses. I.R.C. §§ 447(e); 354(a)(2)(C)(ii).

Prospective regulations may treat preferred stock as something other than stock for other purposes, such as COI and the control requirement. Until such regulations are issued, however, preferred stock will continue to be treated as stock for purposes of other provisions of the I.R.C.[73]

Thus, for example, in the context an ordinary type "A" reorganization, if 70 percent of the consideration is nonqualified preferred stock and the remaining 30 percent is voting common stock, COI will be satisfied. In other words, the statutory amendment, by itself, does nothing to change the characterization of the preferred stock for purposes of evaluating COI. The preferred stock is "disqualified" only for purposes of determining the amount of boot received in the reorganization. Thus, in this example, tax-free treatment is preserved at the corporate level and at the shareholder level, except to the extent the shareholders receive boot.[74]

In January 1998, the IRS and the Treasury finalized regulations that treat certain corporate rights to acquire stock as securities with a zero principal amount in the context of an I.R.C. section 368 reorganization.[75] These regulations provide nonrecognition treatment for a target shareholder that receives rights to acquire stock in the acquiring corporation in a transaction that otherwise qualifies as a tax-free reorganization, provided the shareholder also receives stock of the acquiring corporation.

These final regulations also clarify that I.R.C. section 354 (the provision that provides tax-free treatment at the shareholder level in an I.R.C. section 368 corporate reorganization) does not apply to a shareholder's receipt of rights to acquire stock if the shareholder receives only such rights and no stock of the acquiring corporation. Thus, if a shareholder receives solely boot (and no acquiring corporation stock or acquiring's parent's stock) in a reorganization, the transaction could be treated as a redemption or potentially a liquidation.[76]

The IRS and Treasury also issued regulations[77] to coordinate the finalization of the warrant regulations with enactment of the nonqualified preferred stock rules discussed above. The regulations provide that a right to acquire nonqualified preferred stock received in exchange for stock other than nonqualified preferred stock or for a right to acquire stock other than nonqualified preferred stock will also generally not be treated as stock or a security and may therefore give rise to shareholder gain or dividend income in the context of an I.R.C. section 368 reorganization.[78]

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[73] *See* Pub. L. No. 105-34, 105th Cong., 1st Sess. §1014, 111 Stat. 788 (1997).

[74] The rules regarding nonqualified preferred stock generally apply to issuances of preferred stock after June 8, 1997. Pub. L. No. 105-34 at §1014(f) (1997).

[75] Treas. Reg. § 1.356-3; T.D. 8752, 63 Fed. Reg. 409 (Jan. 6, 1998).

[76] *See* Treas. Reg. § 1.354-1, Ex. 3.

[77] Treas. Reg. § 1.356-6; T.D. 8753, 63 Fed. Reg. 411 (Jan. 6, 1998), *amended by* T.D. 8882, 65 Fed. Reg. 31708 (May 16, 2000).

[78] The regulations regarding warrants and nonqualified preferred stock are generally effective for stock rights received in connection with a transaction occurring on or after March 9, 1998. T.D. 8752, 63 Fed. Reg. 409 (Jan. 6, 1998); T.D. 8753, 63 Fed. Reg. 411 (Jan. 6, 1998).

(h) Substance Over Form and Step Transaction Doctrines

The IRS may apply the Substance Over Form and Step Transaction Doctrines to disregard the separate steps of an integrated transaction and recharacterize the transaction for federal income tax purposes in order to conform the tax consequences of the transaction with its true substance. These doctrines may be applied to recast what appears to be a tax-free transaction into a taxable transaction,[79] or what appears to be a taxable transaction into a tax-free transaction,[80] or to transform one type of tax-free transaction into a different type of tax-free transaction.[81] The proper application (or nonapplication) of the Substance Over Form and Step Transaction Doctrines has been the focus of many cases, IRS pronouncements, and articles and a thorough discussion of this topic is beyond the scope of this treatise. Suffice it to say, the potential application of the Substance Over Form or Step Transaction principles should be carefully analyzed when determining the tax consequences of any multi-step transaction, as things are not always what they appear to be.

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[79] *See Gregory v. Helvering*, 293 U.S. 465 (1935) (regarded by many as the seminal case in the area, existence of a transitory corporation is disregarded to recast a series of otherwise tax-free steps into a taxable transaction); Rev. Rul. 70-140, 1970-1 C.B. 73 (transfer of assets to corporation (target) before target is transferred to acquiring corporation in a "B" reorganization is recast as a taxable sale of the assets to the acquiring corporation followed by the transfer of those assets to the target corporation). *But see Weikel v. Commissioner*, 51 T.C.M. (CCH) 432 (1986) (transaction is not recast in appropriate circumstances); *Vest v. Commissioner*, 57 T.C. 128 (1971), *aff'd in part, rev'd in part*, 481 F.2d 238 (5th Cir. 1973); Rev. Rul 2003-51, 2003-21 I.R.B. 938 (back-to-back I.R.C. section 351 exchanges would not be recast; Revenue Ruling 70-140 distinguished). *See also* Rev. Rul. 68-349, 1968-2 C.B. 143 (transfer of property by an individual to a newly formed corporation does not qualify for tax-free treatment if another corporation makes an accommodating asset transfer for the purpose of qualifying the individual's transfer for tax-free treatment); Rev. Rul. 76-123, 1976-1 C.B. 94 (distinguishing Revenue Ruling 68-349 and respecting a similar transaction); Rev. Rul. 68-357, 1968-2 C.B. 144 (transaction similar to Revenue Ruling 68-349 is not recast because the corporations are participating in reorganizations).

[80] *See, e.g,.* Rev. Rul. 83-142, 1983-2 C.B. 68; Rev. Rul. 78-397, 1978-2 C.B. 150 (disregarding circular cash flows results in tax-free treatment). *See also* Rev. Rul. 80-154, 1980-1 C.B. 68 (foreign corporation's capitalization of undistributed corporate profits treated as a distribution of stock under I.R.C. section 305(a)). See also Rev. Rul. 2004-83; 2004-32 I.R.B. (stock purchase otherwise subject to I.R.C. section 304 followed by a liquidation as a "D" reorganization. Rev. Rul. 2001-46; 2001-2 C.B. 321 (stock purchase other than qualifying as a section 338 qualified stock purchase followed by an upstream merger treated as an "A" reorganization).

[81] *See e.g.,* Rev. Rul. 2001-46, 2001-2 C.B. 321 (I.R.C. section 368(a)(2)(E) reverse triangular merger followed by an "A" reorganization upstream merger of target into acquiring is treated as a single "A" reorganization of target into acquiring); Rev. Rul. 72-405, 1972-2 C.B. 217 (I.R.C. section 368(a)(2)(D) forward triangular merger followed by liquidation of the acquiring corporation treated as a "C" reorganization); Rev. Rul. 67-274, 1967-2 C.B. 141 ("B" reorganization followed by liquidation of target treated as a "C" reorganization). *But see* Rev. Rul 2003-51, 2003-21 I.R.B. 938 (two valid 351 transactions where the first is followed (pursuant to a binding agreement) by a second in which the original transferor transfers the stock received in the first, and a third party transferor transfers other property).

§ 5.3 OVERVIEW OF SPECIFIC TAX-FREE REORGANIZATIONS UNDER SECTION 368

The remainder of this chapter will briefly survey the types of transactions that qualify as acquisitive tax-free reorganizations, focusing first on asset acquisitions, including "A" mergers, "C" reorganizations, forward triangular mergers, and "D" reorganizations; second on stock acquisitions, including "B" reorganizations and reverse triangular mergers; and third on single entity reorganizations, including "E" and "F" reorganizations. Next, this chapter will consider divisive reorganizations (I.R.C. section 355 and "D"/355 transactions). Finally, this chapter will discuss insolvency reorganizations, including "G" reorganizations.

§ 5.4 ACQUISITIVE REORGANIZATIONS

(a) Asset Acquisitions

(i) "A" Reorganization: Merger or Consolidation

I.R.C. section 368(a)(1)(A) provides that one form of reorganization is a statutory merger or consolidation ("A" reorganization). The Treasury Regulations generally require that the transaction be effected pursuant to the laws of the United States or a State or the District of Columbia in order to qualify under this provision.[82] A typical "A" merger is depicted in Exhibit 5.1. As described in greater detail below, the transfer of assets depicted in Exhibit 5.1 could also qualify as a "C," provided the Y stock is voting stock; as a "D," provided the X shareholders are in control of Y after the transaction; and as a "G," provided the transfer is pursuant to title 11 or a similar case.

Although they are similar, a merger and a consolidation are not the same. In a merger, the acquiring corporation is in existence prior to the transaction and it will "survive." If Corporation X and Corporation Y merge, with Corporation X as the target, upon the effective date of the merger the separate existence of Corporation X will cease. Corporation Y will acquire all Corporation X's assets, assume all Corporation X's liabilities, and continue to operate the business of Corporation X (or use a significant portion of Corporation X's assets in its own business). A consolidation, on the other hand, refers to a transaction in which Corporation X and Corporation Y "consolidate" to form a new corporation, Corporation Z. Corporation Z acquires all the assets of both Corporation X and Corporation Y, assumes their liabilities, and continues their businesses (or uses a significant portion of their assets in its business). The difference is that the "survivor" of a consolidation had no existence prior to the reorganization and is a product of the reorganization. The survivor in a consolidation has no ability to carry back post-acquisition losses to a pre-acquisition year; the survivor in a merger can carry back a post-merger loss to its own pre-merger year.[83]

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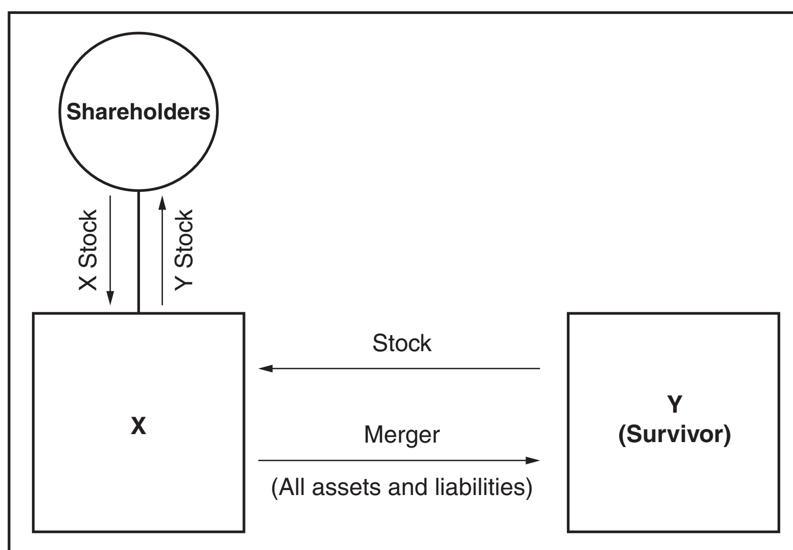
[82] *See* Temp. Treas. Reg. section 1.368-2T(b)(1)(ii) for statutory mergers or consolidations after January 24, 2003 and Treas. Reg. section 1.368-2(b)(1) for mergers or consolidations before that date.

[83] Treas. Reg. § 1.381(c)(1)-1(b), Ex. 1, 2.

EXHIBIT 5.1

Asset Acquisitions "A," "C," "D," and "G"



Otherwise, the tax consequences of both transactions are the same. Because mergers are significantly more common than consolidations, the remaining discussion of I.R.C. section 368(a)(1)(A) will refer to mergers.

In addition, an "A" reorganization will not be disqualified for lack of COBE if the acquiring corporation transfers target's assets to a subsidiary corporation or a partnership within the parameters described in § 5.2(c).

A transaction must be more than a statutory merger to qualify as a reorganization. As discussed above, it must have a bona fide business purpose and must satisfy COBE and COI. There are many mergers for cash and/or notes that qualify as statutory mergers under state law but are not considered tax-free corporate reorganizations. They merely result in a corporate and shareholder level tax, just as if the target corporation had sold its assets and liquidated.[84]

In addition, some state law mergers in which the consideration is stock (and not cash or notes) will also fail to qualify as tax-free "A" reorganizations. For example, the IRS has ruled that certain state law mergers that resemble corporate divisions (rather than amalgamations) cannot qualify as "A" reorganizations.[85] Also, recent proposed and temporary regulations follow the logic of this ruling and deny "A" reorganization treatment to some mergers involving disregarded entities. In general, the temporary and proposed regulations provide

[84] *See, e.g.*, Rev. Rul. 69-6, 1969-1 C.B. 104.

[85] Rev. Rul. 2000-5, 2000-1 C.B. 436 (to qualify as an "A" reorganization, a transaction must result in one corporation acquiring the assets of a target corporation by operation of corporate law merger statute and the target corporation must cease to exist, in contrast to a divisive transaction in which a corporation's assets are divided between two or more corporations).

that the merger of a disregarded entity into a corporation does not qualify as an "A" reorganization, but that the merger of a target corporation into a disregarded entity may qualify as an "A" reorganization.[86]

(ii) "C" Reorganization

(A) Overview

I.R.C. section 368(a)(1)(C) describes two types of asset acquisitions that may qualify as reorganizations: "C" reorganizations and parenthetical "C" reorganizations. The latter is so named because it appears as a parenthetical clause in I.R.C. section 368(a)(1)(C). Section 368(a)(1)(C) reorganizations are often referred to as "practical mergers," because they were instituted at a time when certain state-law mergers were unavailable in some states. "C" reorganizations do, however, impose a number of requirements not imposed by "A" mergers. Foremost among these is the "solely for voting stock" test, described below.

A "C" reorganization is the acquisition by one corporation, solely in exchange for its voting stock, of substantially all the assets of the target corporation. The acquiring corporation may use as consideration stock of a corporation that controls it, yielding a parenthetical "C" reorganization. In addition, in either type of "C" reorganization the acquiring corporation may transfer target's assets to a subsidiary corporation or a partnership within the parameters described in § 5.2(c).

As described below, "C" reorganizations share the "solely for voting stock" requirement with "B" reorganizations. In the latter, this requirement is strictly interpreted. In "C" reorganizations, however, "solely" does not mean "solely." First, I.R.C. section 368(a)(1)(C) specifically provides that the assumption by the acquiring corporation of the liabilities of the target corporation will not, by itself, violate the "solely for" test. Second, I.R.C. section 368(a)(2)(B) provides that, if the acquiring corporation acquires 80 percent of the fair market value of the target corporation's assets solely for voting stock, then nonstock consideration may be used in the exchange without disqualifying the reorganization. (This is commonly referred to as the "boot relaxation rule".)

If such other consideration is used, however, then all assumed liabilities are considered to be money paid for the assets.[87] Even $1 of cash invokes I.R.C. section 368(a)(2)(B), and if the sum of the cash given, other property transferred, and liabilities assumed by the acquiring corporation exceeds 20 percent of the

[86] Temp. Treas. Reg. § 1.368-2T, T.D. 9038, 68 Fed. Reg. 3384 (Jan. 24, 2003); Prop. Treas. Reg. § 1.368-2, REG 126485-01, 68 Fed. Reg. 3477 (Jan. 24, 2003). The new regulations apply to transactions occurring on or after January 24, 2003; taxpayers, however, may apply them in whole, but not in part, to transactions occurring before that date, provided both acquiring and target corporations consistently apply the regulations. This retroactive application creates a dilemma both for taxpayers and the government if both sides (or either side) does not want to follow the new regulations.

[87] I.R.C. § 368(a)(2)(C) previously referred to liabilities to which any acquired property is "subject" in addition to assumed liabilities. This reference was deleted as part of the changes to I.R.C. section 357(c) discussed in § 5.4(a)(iv)(E). Pub. L. No. 106-36, 106th Cong. 1st Sess. § 3001, 113 Stat. 127 (1999) (effective for transfers after October 18, 1998).

value of the target corporation before the transaction, it will not be a valid "C" reorganization. Thus, in general, only corporations with very little debt can be acquired in a valid "C," if the package of consideration includes property other than voting stock. As a result, the vast majority of "C" reorganizations are accomplished solely for voting stock and the assumption of the liabilities of the target corporation.

A 1999 regulation also addresses the "solely for voting stock" requirement in a "C" reorganization.[88] That regulation generally provides that an acquiring corporation's preexisting ownership of a portion of the shares of a target corporation will not, in and of itself, prevent the solely-for-voting-stock requirement of a "C" reorganization from being satisfied. This regulation reverses the IRS's long-standing position (which was confirmed by the Tax Court in *Bausch & Lomb Optical Co. v. Commissioner*[89]) that an acquiring corporation's acquisition of the assets of a partially controlled subsidiary does not qualify as a "C" reorganization.[90]

(B) "Substantially All"

A "C" reorganization requires the acquisition of "substantially all" of the properties (or assets) of the target corporation. Few concepts have proven as difficult to define. The IRS provides a safe harbor rule that "substantially all" means at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets of the target corporation.[91] Courts, however, have accepted significantly less than this amount in satisfaction of the requirement. In *Smothers v. United States,*[92] for example, a transfer of approximately 15 percent of the corporation's net assets qualified.

The safe harbor test makes no distinction between operating assets and investments. Although the question is far from settled, the focus of the inquiry seems to be on operating assets.[93] Dispositions of assets by the target prior to the reorganization may be considered in determining whether substantially all of the target assets have been acquired. Payments of reorganization expenses, payments to dissenting shareholders, redemptions, and partial liquidations are among the transactions that result in a diminution of the target assets and may

[88] Treas. Reg. § 1.368-2(d)(4). The final regulation generally applies to transactions occurring after December 31, 1999. Notwithstanding the effective date, taxpayers can rely on Notice 2000-1 to request a private letter ruling to apply the final regulation to transactions generally occurring on or after June 11, 1999. To receive a favorable ruling, a taxpayer must satisfy the IRS that there is not a significant risk of different parties to the transaction taking inconsistent positions. Notice 2000-1, 2000-1 C.B. 288.

[89] 30 T.C. 602 (1958), *aff'd,* 267 F.2d 75 (2d Cir. 1959).

[90] *See* Rev. Rul. 54-396, 1954-2 C.B. 147.

[91] *See* Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.01.

[92] 642 F.2d 894 (5th Cir. 1981) (involving satisfaction of the substantially all requirement in a "D" reorganization).

[93] *Id. See also Atlas Tool Co. v. Commissioner*, 614 F.2d 860, 865 (3d Cir. 1980); Rev. Rul. 78-47, 1978-1 C.B. 113. In *American Mfg. Co. v. Commissioner*, 55 T.C. 204, 221-22 (1970), substantially all of the assets were transferred for purposes of a "D" reorganization, even though only 20 percent of the assets were acquired, but those assets were all the assets essential to the conduct of the business.

thus have an impact on the substantially all test.[94] The substantially all test is quantitative, not qualitative. Thus, the substitution of one group of assets for other assets will not affect this test, although it could have an impact on the COBE requirement.[95]

(C) Liquidation

Prior to 1984, there was no requirement in a "C" reorganization that the target corporation dissolve following the transfer.[96] Since 1984, the target corporation must distribute all of the stock, securities, and other property received in the reorganization, as well as its other properties.[97] The Commissioner is permitted to waive this requirement.[98] One possible condition to this waiver is that the target corporation and its shareholders treat any retained assets as having been distributed and recontributed to the capital of a new corporation.[99] The waiver is likely to be sought if the target corporation possesses a valuable charter or other attributes inhering to the corporate shell, which would be lost upon dissolution.

A 1989 Revenue Procedure[100] provides that the IRS will issue "C" reorganization rulings notwithstanding the target corporation's failure to satisfy this dissolution requirement, if the following representations are made:

- The target will retain only its charter and those assets necessary to satisfy state law minimum capital requirements;
- Substantially all the assets will be transferred after taking into consideration the value of the retained assets;
- The purpose of the transaction is to isolate the target's charter for resale to an unrelated purchaser;
- As soon as practical, but in no event later than 12 months after substantially all the assets are transferred, the target's stock will be sold.

If relief is provided under Rev. Proc. 89-50, for tax purposes, the charter and retained capital will be treated as distributed and then reincorporated into a new target corporation. This revenue procedure also applies to acquisitive "D" reorganizations, which also must satisfy a dissolution requirement.[101]

(D) Distribution to Creditors

As a result of the Tax Reform Act of 1986, a target corporation will have satisfied the liquidation requirement even if the shareholders receive none of the

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[94] *See generally* Rev. Proc. 77-37, 1977-2 C.B. 568.

[95] *See* Rev. Rul. 88-48, 1988-1 C.B. 117 (valid "C" reorganization where target corporation, prior to the reorganization, sold 50 percent of its historical assets to an unrelated purchaser for cash that was transferred to the acquiring corporation in the reorganization).

[96] Rev. Rul. 68-358, 1968-2 C.B. 156, *obsoleted by* Rev. Rul. 95-71, 1995-2 C.B. 323; Rev. Rul. 73-552, 1973-2 C.B. 116, *obsoleted by* Rev. Rul. 95-71.

[97] I.R.C. § 368(a)(2)(G)(i).

[98] I.R.C. § 368(a)(2)(G)(ii).

[99] H.R. REP. NO. 861, 98th Cong., 2d Sess. 846 (1984).

[100] Rev. Proc. 89-50, 1989-2 C.B. 631.

[101] I.R.C. § 354(b)(1)(B).

acquiring corporation's stock in the reorganization.[102] Distributions to creditors may be sufficient to comply with the liquidation standard and satisfy COI. For this reason, a "C" reorganization, in certain circumstances (e.g., when the corporation is not under title 11) may be an alternative to the "G" reorganization for an insolvent corporation. A fuller discussion of insolvency reorganizations outside of bankruptcy is provided in § 5.8(a).

(iii) Triangular Asset Acquisitions

Triangular reorganizations, as the name implies, involve three corporations: a parent corporation, a subsidiary corporation controlled by the parent corporation, and a target corporation whose stock or assets are acquired in the reorganization.

The I.R.C. specifically provides for four types of triangular reorganizations, two of which involve statutory mergers (the "forward triangular merger," described in I.R.C. section 368(a)(2)(D), and the "reverse triangular merger," described in I.R.C. section 368(a)(2)(E)), and two others (the parenthetical "B" and the parenthetical "C") that do not. In each of these transactions, a corporation (the subsidiary) acquires the stock or assets of the target corporation (target) in exchange for stock of a corporation in control of the acquiring corporation (parent). Thus, the parent, subsidiary, and target form the three sides of the "triangle." The triangular asset reorganizations will be discussed here, and the triangular stock acquisitions will be discussed in § 5.5(b).

Exhibit 5.2 shows the form of a triangular asset acquisition under I.R.C. section 368(a)(2)(D) or section 368(a)(1)(C) (parenthetical clause). Provided the parent's stock is voting stock, this transaction qualifies as a parenthetical "C" as well.[103] Again, although there is no requirement in a "C" that the assets move via a merger, there is no prohibition either.

In a forward triangular merger, the subsidiary can be a newly formed corporation established merely to effectuate the transaction or an existing corporation with substantial business assets. As a practical matter, about 90 percent of all forward triangular acquisitions involve newly established subsidiaries.

In a forward triangular merger, the target corporation is merged into the subsidiary with the subsidiary surviving. Unlike a straight "A" reorganization, the subsidiary must acquire *substantially all* of the assets of the target.[104] However, no stock of the subsidiary may be issued in the transaction.[105] Rather, stock of the parent, which must be in control of the subsidiary, is issued to the target in the exchange. Although only stock of the parent may be issued, it is permissible to use nonstock consideration (i.e., cash, parent debt, subsidiary debt, etc.) or

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[102] I.R.C. § 368(a)(2)(G)(i), second sentence.

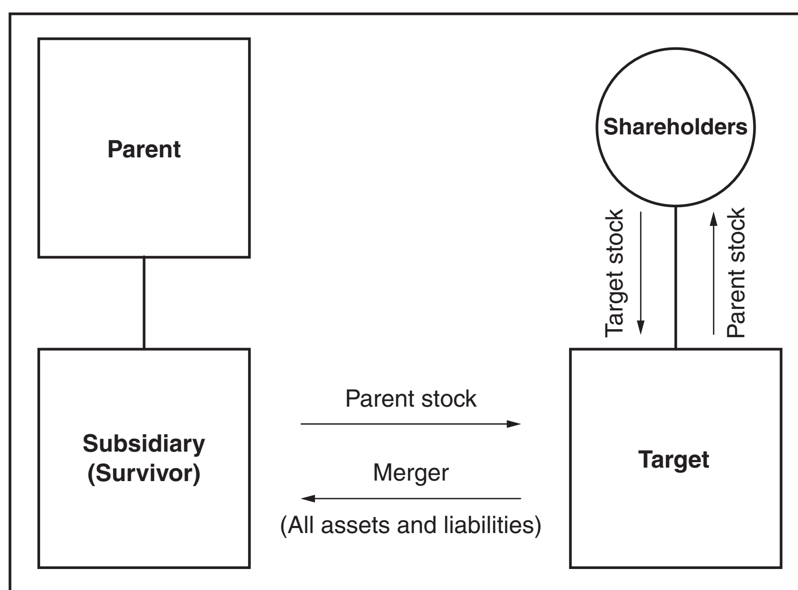
[103] If boot is issued, however, the transaction may be disqualified as a "C" reorganization, but it may still qualify as an I.R.C. section 368(a)(2)(D) forward triangular merger. *See* § 5.4(a)(ii) discussion of boot relaxation rule in a "C" reorganization and § 5.4(a)(iii) discussion of boot in a forward triangular merger.

[104] "Substantially all" has the same meaning for purposes of I.R.C. section 368(a)(2)(D) as discussed for a "C" reorganization in § 5.4(a)(ii)(B). Treas. Reg. § 1.368-2(b)(2).

[105] I.R.C. § 368(a)(2)(D); Treas. Reg. § 1.368-2(b)(2).

EXHIBIT 5.2

Forward Triangular Merger and Parenthetical "C"



to have either the parent or the subsidiary, or both, assume the liabilities of the target.[106]

Special basis rules apply to triangular reorganizations. In a forward triangular merger or triangular "C" reorganization, the parent corporation's basis in its subsidiary stock is adjusted as if (1) parent acquired the target corporation assets that were acquired by the subsidiary (and parent assumed any liabilities which subsidiary assumed) directly from target in a transaction in which parent's basis in target's assets was determined under I.R.C. section 362, and then as if (2) parent transferred those assets (and liabilities) to subsidiary in a transaction in which parent's basis in the subsidiary stock was determined under I.R.C. section 358.[107] This is commonly referred to as the "over-the-top" model.

[106] Treas. Reg. § 1.368-2(b)(2); Rev. Rul. 79-155, 1979-1 C.B. 153. Sufficient stock must be issued to satisfy the COI requirement discussed in § 5.2(d).

[107] Treas. Reg. § 1.358-6(c)(1). If the liabilities that were assumed exceed target's basis in its assets, the amount of the adjustment would be zero and parent would not recognize gain under I.R.C. section 357(c). The amount of parent's basis in its stock in subsidiary would be decreased by the value of any consideration not provided by parent, however. This provision does not apply to target liabilities assumed by the subsidiary. In addition, there is no adjustment to parent's basis in subsidiary stock if the decrease resulting from subsidiary-provided consideration equals or exceeds the general basis increase resulting from the over-the-top model. Treas. Reg. § 1.358-6(d). If parent and subsidiary file a consolidated return, parent will be required to reduce its basis by such excess, which could result in negative basis or an excess loss account. Treas. Reg. § 1.1502-30.

EXAMPLE 5.1

Facts: T has assets with a basis of $60 and a fair market value of $100 and no liabilities. P forms S with $10 (which S retains) and T merges into S in exchange for $100 worth of P stock.

Analysis: The merger qualifies as a forward triangular reorganization under I.R.C. section 368(a)(2)(A). P's $10 of basis in the T stock is adjusted as if P acquired the T assets directly from T in the reorganization. Under I.R.C. section 362, T would have a $60 basis in the T assets. P is then treated as if it transferred the T assets to S. P's $10 basis would be increased by $60 to $70 pursuant to I.R.C. section 358.

As with an "A" reorganization, a forward triangular merger is not disqualified if the acquiring corporation (subsidiary) transfers target's *assets* to a corporation controlled by subsidiary.[108] This concept has been expanded to include multiple drops and transfers to partnerships within the parameters described in § 5.2(d), above. Further, the subsidiary *stock* may be transferred by parent to another subsidiary controlled by parent following the forward triangular merger.[109]

(iv) Acquisitive "D" Reorganization

(A) Overview

I.R.C. section 368(a)(1)(D) provides that a reorganization includes a transfer by a corporation of all or part of its assets to another corporation if, immediately after the transfer, the transferor corporation or one or more of its shareholders (or a combination thereof) are in control of the transferee corporation; but only if the stock of the transferee corporation is distributed pursuant to I.R.C. section 354, 355, or 356. (See Exhibit 5.1 for an example of a "D" reorganization.) Because the focus of the reorganization provisions here is on acquisitive transactions, the I.R.C. section 355 ramifications of a divisive "D" reorganization (spin-off, split-off, and split-up) will be discussed separately in § 5.7.

(B) "Substantially All"

In a "D" reorganization, the target corporation must transfer substantially all of its assets to the acquiring corporation.[110] The same rules (including rulings and case law) that define "substantially all" for purposes of a "C" reorganization define substantially all for purposes of a "D" reorganization. Most of the cases in this area involve efforts by the government to establish a "D" reorganization when the taxpayer is seeking to avoid reorganization treatment and obtain the more favorable treatment afforded liquidations under pre-1986 tax law.

The transfer of the assets from target to acquiring corporation will meet the substantially all definition even if that transfer is small, indirect, or convoluted.[111]

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[108] Rev. Rul 72-576, 1972-2 C.B. 217.

[109] Rev. Rul. 2001-24, 2001-1 C.B. 1290.

[110] *See* I.R.C. § 354(b)(1)(A).

[111] In *Simon v. Commissioner*, 644 F.2d 339, 343 (5th Cir. 1981), the substantially all requirement was satisfied even though the target corporation's principal operating asset, a non-assignable franchise, was transferred to the acquiring corporation by an unrelated party, albeit through the efforts of the individuals who wholly owned both target and acquiring.

(C) Distribution of Stock

To qualify as an acquisitive "D" reorganization, the stock of the acquiring corporation received by the target corporation in exchange for its assets must be distributed to the shareholders of the target corporation in a transaction qualifying under I.R.C. section 354 or 356. I.R.C. section 354(b)(1)(A) provides that the acquiring corporation must acquire "substantially all" of the assets of the target corporation, and I.R.C. section 354(b)(1)(B) provides that the target corporation must dissolve and distribute its remaining properties to its shareholders. Failing either of the above, the transfer of assets will not qualify as a "D" reorganization, because I.R.C. section 354 will not apply. I.R.C. section 356 applies only when, in exchange for its assets, the target corporation receives property other than stock or securities of the acquiring corporation. As provided in I.R.C. section 356(a)(1)(A), I.R.C. section 356 will apply only if, but for the receipt of the other property, I.R.C. section 354 would have applied. Again, it will be necessary to comply with the requirement to transfer substantially all of the assets and to dissolve the target corporation.

The IRS and the courts have deemed stock to be issued and thus have deemed the I.R.C. section 354 requirement satisfied if there are common shareholder interests in both the target corporation and the acquiring corporation, rendering the distribution of stock a meaningless gesture.[112] Thus if parent corporation owns all of the stock of both the target corporation and acquiring corporation and target (1) sells all of its assets to acquiring for cash and then (2) liquidates, distributing the cash to its shareholder, the I.R.C. section 354 distribution requirement will be deemed to be satisfied and the transaction will be treated as a "D" reorganization. The import of this is that the nonstock consideration (i.e., boot) that is distributed to the shareholder may be treated as a "boot" dividend.[113] The I.R.C. section 354 distribution requirement would not be deemed to be satisfied if the shareholding in the target and acquiring corporations is not substantially identical.[114]

The IRS has historically taken the position that an actual liquidating distribution of assets by a corporation (X) followed by a transfer (reincorporation) of its assets by the shareholders to another commonly owned corporation (Y) may similarly be treated as a "D" reorganization of X into Y. However, if X merges upstream into its *parent* corporation, there is long-standing precedent that the form of the transaction should be respected and the transaction treated as an upstream "A" reorganization of X into parent corporation followed by an I.R.C. section 368(a)(2)(C) transfer of assets by parent corporation to Y.[115] The IRS has

[112] *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980); *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961); *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970); Rev. Rul. 70-240, 1970-1 C.B. 81. *See also* P.L.R. 9111055 (Dec. 19, 1990) (extending this analysis to target corporation owned by daughter and acquiring corporation owned by mother).

[113] *See* I.R.C. § 356(a)(2) and cases *supra* note 112.

[114] *Warsaw Photographic Assocs., Inc. v. Commissioner*, 84 T.C. 21, 37 (1985).

[115] Rev. Rul. 69-617, 1969-2 C.B. 57 (ruling based on fact pattern that included a minority shareholder).

shown signs of extending this practice to transactions that are not accomplished by means of an upstream merger.[116]

(D) Control

In an acquisitive "D" reorganization, the transferor corporation or its shareholders must be in control of the acquiring corporation. Solely for this purpose, control means 50 percent of the vote or value. Attribution rules are also used to determine control. Thus, if X corporation (wholly owned by P corporation) transfers substantially all its assets to Y corporation (wholly owned by Q corporation), the transaction will qualify as a "D" reorganization if P is owned by individual M and Q is owned by M's father.[117]

(E) Section 357(c)

Many "A" reorganizations, as well as reorganizations that would otherwise qualify as "C" reorganizations, are also "D" reorganizations. This overlap may result in the imposition of tax if care is not taken in structuring the transaction. In an overlap between an "A" and a "D" reorganization, tax will be imposed if the liabilities of the target corporation assumed by the acquiring corporation exceed the basis of the assets transferred. The tax is imposed by I.R.C. section 357(c). This section does not apply to "A" reorganizations, but it does apply to "D" reorganizations. The IRS has determined that, in an overlap situation, the tax will be imposed if applicable.[118]

Prior to the statutory amendments discussed below, I.R.C. section 357(c) required the transferor of the property in an I.R.C. section 351 exchange[119] or in a "D" reorganization to recognize gain to the extent that the *assumed* liabilities plus the liabilities to which the transferred property was *subject*, exceeded the transferor's basis in the transferred property. Following the transfer, the basis of the property in the hands of the controlled corporation would equal the transferor's basis in such property, increased by the amount of gain recognized by the transferor, including I.R.C. section 357(c) gain.

The IRS had won several cases that held that the I.R.C. section 357(c) "subject to" language could result in the recognition of gain even if there was no economic gain.[120] When taxpayers began to use these otherwise adverse precedents as a sword, Congress got worried. For example, I.R.C. section 357(c) gain could ostensibly be used by a foreign transferor that was not subject to United States tax to achieve for a domestic transferor corporation basis in assets in excess of their value.[121]

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[116] *See, e.g.,* P.L.R. 200250024 (Sept. 4, 2002); P.L.R. 200028027 (Apr. 18, 2000).

[117] I.R.C. § 368(a)(2)(H) incorporates the attribution rules of I.R.C. § 304.

[118] *See* Rev. Rul. 75-161,1975-1 C.B. 114.

[119] For a brief discussion of I.R.C. section 351 *see supra* § 2.4(c)(ii)(A).

[120] *See Focht v. Commissioner*, 68 T.C. 223 (1977).

[121] In addition, certain transactions (usually in the context of an I.R.C. section 351 exchange) involving liabilities could also result in duplication or acceleration of losses. I.R.C. sections 357(d), 358(d), and (h) were amended to address such issues. Pub. L. No. 106-554, 106th Cong. 2d Sess. § 309, 114 Stat. 2763 (2000); Pub. L. No. 107-147, 107th Cong. 2d Sess. § 412, 116 Stat. 21 (2002).

Congress therefore amended I.R.C. sections 357(c), 357(d), and 362(d) to eliminate the reference to "liabilities to which property is subject" and to provide a framework for how to deal with liabilities.[122] In doing so, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability was generally eliminated. Under the new provision, a recourse liability (or any portion thereof) is treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to satisfy the liability or portion thereof (whether or not the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be expected to satisfy such liability or portion thereof. A nonrecourse liability (or any portion thereof) is treated as having been assumed by the transferee of any asset that is subject to the liability. This amount is reduced, however, if an owner of other assets subject to the same nonrecourse liability agrees with the transferee to, and is expected to, satisfy the liability. This exception only applies to the extent of the fair market value of the other assets that secure the liabilities.[123] In determining whether any person has agreed to and is expected to satisfy a liability, all facts and circumstances are to be considered.[124]

In addition, the basis of the transferred property may generally not be increased due to I.R.C. section 357(c) gain in excess of the fair market value of the property. If gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that also is secured by any assets not transferred to the corporation, and if no person is subject to federal income tax on such gain, then for purposes of determining the basis of assets transferred, the amount of gain treated as recognized as a result of the assumption is determined as if the liability assumed by the transferee equaled the transferee's ratable portion of the liability, based on the relative fair market values of all assets subject to the nonrecourse liability.[125]

The Treasury Department has been granted authority to prescribe regulations to carry out the purposes of the provision. Although these amendments were enacted in 1999, 2000, and 2002, the provision is effective for transfers on or after October 19, 1998.

Two commonly controlled corporations that would otherwise have an I.R.C. section 357(c) gain due to the overlap of the "A" and "D" reorganization provisions can easily avoid the problem by merging, or otherwise transferring their assets, in the opposite direction. For example, assume that P owns 60 percent of the stock of X and 100 percent of the stock of Y. X is otherwise solvent, but the

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[122] Pub. L. No. 106-36, 106th Cong. 1st Sess. § 3001, 113 Stat. 127 (1999).

[123] I.R.C. § 357(d)(2). Fair market value is determined without regard to I.R.C. section 7701(g), which provides that for purposes of determining gain or loss on property, the fair market value of property shall not be treated as being less than the amount of any nonrecourse debt to which the property is subject.

[124] *See also* REG-100818-01, 68 Fed. Reg. 23931 (May 6, 2003) (advance notice of proposed rulemaking soliciting comments on forthcoming I.R.C. section 357(d) proposed regulations).

[125] I.R.C. § 362(d). Fair market value for this purpose is determined without regard to I.R.C. section 7701(g). *See supra* note 123.

liabilities of X exceed the basis of its assets. A transfer by X to Y of substantially all assets for stock of Y (representing 20 percent of the outstanding Y stock) will qualify as a reorganization but will cause X to recognize under I.R.C. section 357(c) a gain equal to the difference between the liabilities assumed over the basis of the assets. However, a merger of Y into X, in which Y transfers substantially all of its assets to X, will be tax-free and will not result in an I.R.C. section 357(c) gain. The gain can be recognized only by a corporation that has excess liabilities and that transfers its assets.

It should also be noted that I.R.C. section 357(c) will generally not apply to transfers between members of a consolidated group.[126] This exception will not apply, however, to a transaction if the transferor or transferee becomes a nonmember as part of the same plan or arrangement.[127]

In addition to the I.R.C. section 357(c) tax problem, if the transaction in question is an overlap between a "C" and a "D" reorganization, then the target corporation may not be free to remain in existence, even on the limited basis permitted by the Tax Reform Act of 1984. The reason for this is that I.R.C. section 368(a)(2)(A) provides that if a transaction is described in I.R.C. sections 368(a)(1)(C) and (a)(1)(D), then it will be treated only as a "D" reorganization.[128] As stated above, in order to qualify as a "D" reorganization, the target corporation must dissolve. Failure to do so may cause the transaction to be treated as a fully taxable sale of assets. Notwithstanding this rule, the IRS has permitted insurance companies in "D" reorganizations to separate charters from operating assets in a manner similar to that permitted in "C" reorganizations.[129]

A final matter with respect to "D" reorganizations involves a recently resolved issue concerning "D" reorganizations and I.R.C. section 368(a)(2)(C). As described above, I.R.C. section 368(a)(2)(C) allows post-reorganization transfers to controlled corporations after an "A", "B," or "C" reorganization. As discussed in § 5.2(c), recent regulations have extended such transfers to corporations that are members of qualified groups and, in certain instances, to partnerships. I.R.C. section 368(a)(2)(C) does not include "D" reorganizations in the list of reorganizations that permit postacquisition drops. In Rev. Rul. 2002-85,[130] the IRS concluded that an acquiring corporation's transfer of a target corporation's assets to a subsidiary controlled by the acquiring corporation will not prevent a transaction from qualifying as a "D" reorganization.

§ 5.5 STOCK ACQUISITIONS

In general, an acquiring corporation can acquire the *stock* (as opposed to the assets) of a target corporation in one of two ways: a "B" reorganization or an I.R.C. section 368(a)(1)(A)/(a)(2)(E) reverse triangular merger. The distinguishing

[126] Treas. Reg. § 1.1502-80(d). This rule applies if it occurs in a consolidated return year beginning on or after January 1, 1995.
[127] Treas. Reg. § 1.1502-80(d)(1).
[128] *See* Rev. Rul. 74-545, 1974-2 C.B. 122.
[129] *See* I.R.C. § 368(a)(2)(G); Rev. Proc. 89-50, 1989-2 C.B. 631.
[130] 2002-2 C.B. 986.

feature of these two types of tax-free reorganizations is that in each the target corporation survives.

(a) "B" Reorganization

(i) Overview

As with "C" reorganizations discussed above, I.R.C. section 368(a)(1)(B) describes two types of stock acquisitions that may qualify as reorganizations: "B" reorganizations and parenthetical "B" reorganizations. The latter is so named because it appears as a parenthetical clause in I.R.C. section 368(a)(1)(B).[131] Exhibit 5.3 presents diagrams of these two transactions. In a "B" reorganization, the acquiring corporation exchanges shares of its own voting stock for the stock of the corporation it wishes to acquire. In a parenthetical "B" reorganization, the acquiring corporation exchanges stock of a corporation that controls it (i.e., its parent) for the stock of the corporation it wishes to acquire.[132] In either type of transaction, the consideration given to the target corporation's shareholders must consist solely of voting stock and the acquiring corporation must be "in control" of the target corporation after the transaction. In addition, in either type of "B" reorganization the stock of the target may be subsequently transferred by acquiring to a subsidiary within the parameters discussed in § 5.2(c).[133]

(ii) "Solely for Voting Stock"

The major issue in either type of "B" reorganization is whether the acquisition was accomplished "solely for voting stock." In the context of a "B" reorganization, the "solely" requirement is strictly construed. The only exception is that cash may be paid for fractional share interests.[134] The IRS has determined that warrants, options, or stock that is restricted from voting for 5 years will not satisfy the solely for voting stock requirement.[135] Stock is considered voting stock, however, if it is restricted from voting because it is held by a subsidiary.[136] Nonvoting stock that is convertible into voting stock is not considered voting stock until it is converted.[137] Stock that gives its owner the right to participate in management through the election of corporate directors will *generally* satisfy the test.[138] The solely for voting stock requirement is not violated if the target shareholders receive cash or other property (1) from the target corporation as a divi-

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[131] *See* Treas. Reg. §§ 1.358-6 and 1.1502-30 to determine parent corporation's adjustment to basis in stock of its subsidiary in the context of a parenthetical "B" reorganization.

[132] *See supra* § 5.2(e) for a general discussion of "control."

[133] The stock of the target corporation may not, however, be transferred to a partnership if the control requirement would be violated. *See* Treas. Reg. § 1.368-2(k), Ex. 3; *see infra* § 5.5(a)(iii).

[134] Rev. Rul. 66-365, 1966-2 C.B. 116, *amplified by* Rev. Rul. 81-81,1981-1 C.B. 122.

[135] *See* Treas. Reg. § 1.354-1(e); Rev. Rul. 72-72, 1972-1 C.B. 104; Rev. Rul. 70-269, 1970-1 C.B. 82, *amplified by* Rev. Rul. 98-10, 1980-1 C.B. 643; Rev. Rul. 69-91, 1969-1 C.B. 106.

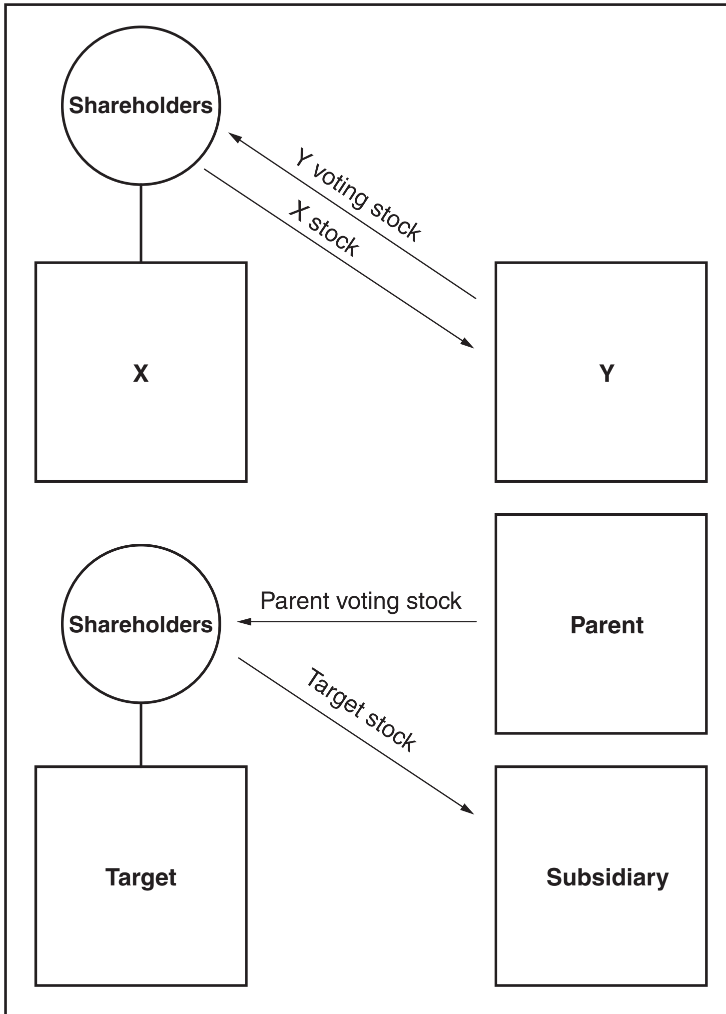
[136] Rev. Rul. 73-28, 1973-1 C.B. 187.

[137] Rev. Rul. 71-83, 1971-1 C.B. 268.

[138] *See supra* notes 52-53 and accompanying text.

EXHIBIT 5.3

Stock Acquisition "B" (top) and Parenthetical Stock Acquisition—Parenthetical "B" (bottom)



dend or in redemption of stock prior to and as part of a "B" reorganization,[139] or (2) from the acquiring corporation in exchange for a nonshareholder interest (i.e., a debenture, an employment agreement, a leasehold, or real property).[140]

[139] *See* Rev. Rul. 69-443, 1969-2 C.B. 54; Rev. Rul. 55-440, 1955-2 C.B. 226.

[140] In Rev. Rul. 69-142, 1969-1 C.B. 107, the IRS determined that the parties had undertaken a valid "B" reorganization but that a simultaneous exchange of debentures was a separate taxable exchange. Rev. Rul. 98-10, 1998-1 C.B. 643, affirms the conclusion in Rev. Rul. 69-142 that the solely for voting stock requirement is not violated by a concomitant exchange by debenture holders. More importantly, instead of treating the debenture exchange as a taxable exchange, Rev. Rul. 98-10 provides that I.R.C. section 354 applies to the debenture exchange (and a tax-free exchange occurs), provided the debentures constitute securities for purposes of I.R.C. section 354(a)(1).

In a "B" reorganization, the acquiring corporation cannot acquire "control" (i.e., I.R.C. section 368(c) control—80 percent vote and 80 percent each class of nonvoting stock) solely for voting stock of the target corporation and then acquire the remainder for cash or other consideration. The IRS has unequivocally denied reorganization status to such a transaction,[141] and the courts have agreed.[142] Moreover, the acquiring corporation cannot do indirectly through a subsidiary what it could not do directly. Thus, if P corporation acquires 90 percent of the stock of target corporation (T) solely for P voting stock, and S (a wholly owned subsidiary of P) acquires the balance of the T stock for cash, P's acquisition cannot qualify as a "B" reorganization.[143]

The solely-for-voting-stock requirement can also be violated in a number of subtle ways. The assumption of a shareholder liability[144] (even pursuant to a merger concurrent with the "B" reorganization[145]), the complete liquidation of a wholly owned subsidiary corporation that holds target corporation stock needed to obtain control,[146] and unreasonable payments to a shareholder-employee for compensation or a covenant-not-to-compete will all violate the solely for voting stock requirement.

An improvident purchase of target stock for cash in a prior period may preclude a later B reorganization. If the first step (cash purchase) is integrated with the later stock-for-stock exchange, the solely for voting stock requirement will be violated. If, on the other hand, the first step (cash purchase) is "old and cold," then the later exchange should qualify as a "B" reorganization. Thus, a cash purchase by X corporation of 40 percent of T corporation four years ago would not preclude a "B" reorganization today, if X corporation acquires the remaining 60 percent solely for X's voting stock. However, if the prior cash purchase was 4 months ago, the later 60 percent acquisition would probably not be a valid "B." Prior cash purchases can, however, be "purged" by selling the cash-purchased stock in the open market and reacquiring it in exchange for voting stock.[147]

(iii) Control

In a "B" reorganization, the control requirement focuses on control immediately after the reorganization. The fact that the acquiring corporation was already in control of the target corporation is immaterial. Thus, if X wants to acquire the

[141] Rev. Rul. 75-123, 1975-1 C.B. 115.

[142] *See Heverly v. Commissioner*, 621 F.2d 1227 (3d Cir. 1980); *Chapman v. Commissioner*, 618 F.2d 856 (1st Cir. 1980).

[143] Rev. Rul. 85-139, 1985-2 C.B. 123. *Cf.* Rev. Rul. 68-562, 1968-2 C.B. 157 (valid "B" reorganization where individual shareholder owning 90 percent of P purchased 50 percent of T's stock for cash; P then acquired 100 percent of the T stock (including the stock held by the individual shareholder) solely for voting stock of P). The distinction between the two revenue rulings is probably based on the fact that S, in this context, is treated as the alter ego of P, a corporation. An individual (even a majority shareholder), however, is not an alter ego, but is a separate taxpayer whose actions are not attributable to the corporation.

[144] Rev. Rul. 79-4, 1979-1 C.B. 150; *cf.* Rev. Rul. 79-89, 1979-1 C.B. 152.

[145] Rev. Rul. 70-65, 1970-1 C.B. 77.

[146] Rev. Rul. 69-294, 1969-1 C.B. 110; *cf.* Rev. Rul. 69-585, 1969-2 C.B. 56.

[147] Rev. Rul. 72-354, 1972-2 C.B. 216.

stock of M in a "B" reorganization, it does not matter (for the control test) whether X has zero, 10 percent, 50 percent, 80 percent, or 99 percent of the stock of M beforehand. Even acquisitions of a small amount of M stock for voting stock of X can be valid "B" reorganizations if X is in control (80 percent test) after the exchange. These types of acquisitions are sometimes referred to as "mini-Bs." But, as stated above, the pre-existing ownership in M must not violate the solely for voting stock test, *that is*, it must be either "old and cold" or previously acquired for X's voting stock.

(b) Reverse Triangular Mergers

(i) Overview

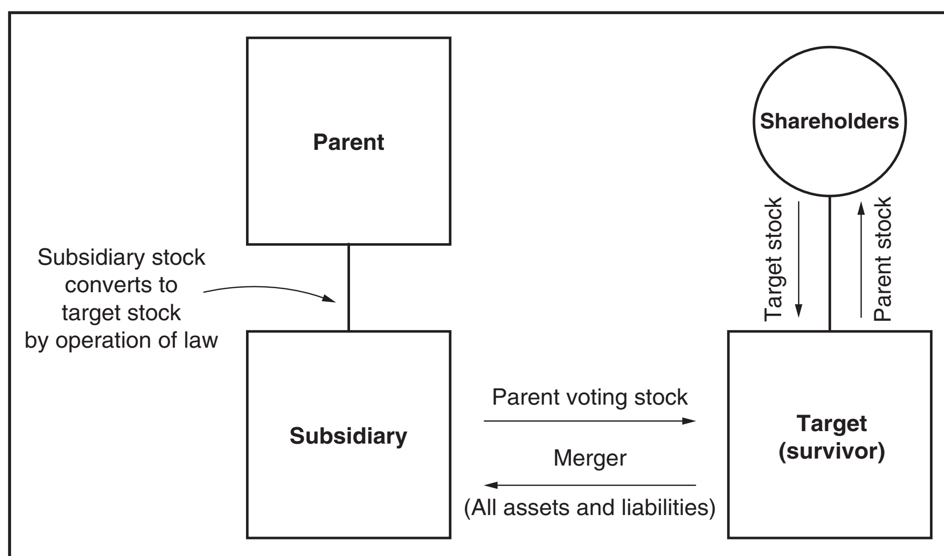
As noted above, there are two types of triangular mergers: the "forward triangular merger," described in I.R.C. section 368(a)(2)(D), and the "reverse triangular merger," described in I.R.C. section 368(a)(2)(E). Exhibit 5.4 shows the form of a reverse triangular merger.

As with a forward triangular merger, the reverse triangular merger also involves a merger of a subsidiary and target. However, the merger is "reversed": the subsidiary merges into the target and the target is the surviving corporation. In this transaction, too, the subsidiary can be a newly formed corporation established merely to effectuate the transaction or an existing corporation with substantial business assets. As a practical matter, about 99 percent of all reverse triangular acquisitions involve newly established subsidiaries.

In a reverse triangular merger, the target must acquire substantially all the properties of the subsidiary, and, after the transaction, the target must hold substantially all of its own properties and substantially all of the properties of the

EXHIBIT 5.4

Reverse Triangular Merger



subsidiary.[148] In the transaction, and by operation of law, the formerly outstanding stock of the subsidiary is converted into shares of stock of the target, and the target shareholders exchange their target stock for voting stock of the parent. The result is that the target becomes a wholly owned subsidiary of the parent. To qualify the merger as a reverse triangular merger, the former shareholders of the target must exchange an amount of target stock constituting control,[149] solely for voting stock of the parent.[150] Thus, in addition to the "substantially all" test, which applies to the forward triangular merger, there is a solely for voting stock test similar to that used in a "B" reorganization. However, unlike the "B" reorganization, a reverse triangular merger accomplished for 80 percent voting stock of the parent and 20 percent other consideration is permissible.

When a target corporation is in bankruptcy or a similar proceeding, the requirement that the former shareholders of the target exchange an amount of their stock constituting control solely for voting stock of the parent is modified. The creditors of the target are permitted to step into the shoes of the shareholders and receive parent's stock. In such cases, it is not necessary that the former target shareholders receive any consideration.[151] The parent must acquire control (80 percent of the voting stock and 80 percent of each class of nonvoting stock) of the subsidiary in the transaction. Thus, if the parent already has a preexisting "old and cold" interest in the target that is in excess of 20 percent of the voting stock or 20 percent of any class of nonvoting stock, the parent cannot acquire control in the transaction and the transaction will not qualify under I.R.C. section 368(a)(2)(E). However, if no cash is used in the transaction, the exchange may qualify as a "B" reorganization, because "creeping control" is permitted in a "B." Otherwise, a taxable exchange results.[152] In determining whether the 80 percent test is satisfied, any shares redeemed for nonstock consideration supplied by the target (as opposed to the parent) is disregarded and such shares are not considered outstanding for purposes of the test.[153] The IRS has recently favorably determined that a tender offer by a parent or a transitory subsidiary, to obtain a certain percentage of target stock, followed by a reverse triangular merger satisfies the "control-for-voting-stock" requirement of I.R.C. § 368(a)(2)(E)(ii) when the tender offer and the merger are part of the same series of integrated steps to acquire a target corporation.[154]

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[148] I.R.C. § 368(a)(2)(E)(i).

[149] *See supra* § 5.2(e).

[150] I.R.C. § 368(a)(2)(E)(ii).

[151] I.R.C. § 368(a)(3)(E).

[152] *See* Treas. Reg. § 1.368-2(j)(6), Ex. 4, 5. *See also* Rev. Rul. 67-448, 1967-2 C.B. 144.

[153] *See* Treas. Reg. § 1.368-2(j)(6), Ex. 2, 3.

[154] Rev. Rul. 2001-26, 2001-1 C.B. 1297. The IRS also ruled that if, pursuant to a plan, a newly formed wholly owned subsidiary of an acquiring corporation merges into a target corporation, followed by the merger of the target corporation into the acquiring corporation, the transaction is treated as a single statutory merger of the target corporation into the acquiring corporation that qualifies as a reorganization under I.R.C. § 368(a)(1)(A). Rev. Rul. 2001-46, 2001-2 C.B. 321. *See generally* § 5.2(h) regarding Substance Over Form and Step Transaction Doctrines.

(ii) Basis

The basis adjustment to parent corporation's basis in the target stock for a reverse triangular merger will generally be the same as the basis adjustment in the context of a forward triangular merger. Namely, a deemed over-the-top transaction will determine parent's basis or adjustment to basis in the target stock.[155] However, if the reverse triangular merger also qualifies as a section 351 exchange or a "B" reorganization, the parent will be given its choice to follow the over-the-top approach or to determine its basis by reference to the former shareholder's basis in the target stock under I.R.C. section 362(b).[156]

(iii) "Substantially All," "Drops," and "Push-Ups"

The "substantially all" test applied in the reverse triangular merger is the same test applicable to the "C," parenthetical "C," "D," and forward triangular reorganizations.[157] In each of these transactions, the I.R.C. requires that there be an "acquisition" of substantially all the properties of the target corporation. However, in the reverse triangular merger, there is the additional requirement that the target "hold" substantially all of its own properties as well as substantially all those of the subsidiary. Despite such statutory language, a reverse triangular merger will not be disqualified by reason of the fact that all or part of the target corporation's assets or stock acquired in the transaction are "dropped" (transferred or successively transferred) to one or more corporations controlled in each transfer by the transferor corporation within the meaning of I.R.C. section 368(c).[158] The IRS, however, has recently ruled in Rev. Rul. 2001-25 that a reverse triangular merger will not fail the "substantially all" requirement if the surviving corporation sells a portion of its assets immediately after and as part of the plan of merger, provided the corporation continues to hold the sales proceeds.[159]

A related question is whether a distribution by the target to the acquiring corporation of a significant portion of its assets could disqualify an acquisition from treatment under I.R.C. section 368(a)(2)(E) on the ground that the target did not continue to "hold" substantially all of its assets. The IRS has ruled favorably that a distribution by the acquiring corporation of a portion of the assets acquired in a forward triangular merger will not disqualify the transaction from treatment under I.R.C. section 368(a)(2)(D) (forward triangular

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[155] Adjustments, however, may be required if P acquired less than all of T's stock in the transaction. *See* Treas. Reg. § 1.358-6(c)(2)(i).

[156] Treas. Reg. § 1.358-6(c)(2)(ii).

[157] Treas. Reg. § 1.368-2(j)(3)(iii).

[158] Treas. Reg. § 1.368-2(k)(2). The assets of the target could be transferred to a partnership as discussed in § 5.2(c) if the "control" requirement is not violated. *See* Treas. Reg. § 1.368-2(k), Ex. 3.

[159] 2001-1 C.B. 1291.

merger).[160] The IRS has not historically ruled to this effect for reverse triangular reorganizations. This dichotomy stems from the I.R.C. section 368(a)(2)(D) language providing that a forward triangular reorganization involves the "acquisition" of substantially all of the targets assets as compared to the I.R.C. section 368(a)(2)(E) requirement that the target "hold" substantially all of its assets and the assets of the merged corporation after the transaction. Nevertheless, Rev. Rul. 2001-25 (discussed in preceding paragraph) includes language that goes beyond a substitution of assets theory.[161] The ruling also notes that the use of the word "holds" rather than "acquisition" does not impose requirements on the surviving corporation that would not have applied had the transaction been a "C" reorganization or an I.R.C. section 368(a)(2)(D) forward triangular reorganization. This seems to open the door for nonliquidating asset distributions following a reverse triangular merger, provided such distributions do not effect a distribution of substantially all of target's assets or such distributions do not involve a subsequent distribution that may violate the COBE requirement.[162]

(iv) Forward and Reverse Mergers: Other Consequences

Both forward and reverse triangular mergers can be achieved within a single existing corporate structure. Assume that P owns all of the stock of S and S owns all of the stock of T. The merger of P into T (T surviving) for S stock (causing the existing P shareholders to surrender their P stock for S stock) is a forward triangular merger. However, the merger of T into P (P surviving) for S stock (causing the former P shareholders to surrender their P stock for S stock) is a reverse triangular merger.[163] The only difference between the two transactions is the identity of the surviving corporation. However, dramatically different tax conse-

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[160] *See* G.C.M. 36111 (Dec. 18, 1974) (determining that a merger of a target corporation into a parent corporation's wholly owned subsidiary in exchange for parent stock followed by a "push-up" of approximately 80 to 85 percent of the value of target's assets (shares of parent stock) qualifies as a forward triangular merger); P.L.R. 9215032 (Jan. 10, 1992) (finding that a distribution of assets after a forward triangular merger will be disregarded in determining whether the "substantially all" requirement is satisfied). However, if the "pushed-up" assets constitute substantially all of the target's assets, the IRS is more likely to recast the transaction in a taxable form. *See* G.C.M. 37905 (Mar. 29, 1979) (amplifying G.C.M. 36111 to provide that a merger of a target corporation into a parent corporation's wholly owned subsidiary in exchange for parent stock followed by a "push-up" of substantially all of target's assets will not be treated as a forward triangular merger but alternatively will be viewed as a direct acquisition of assets by the parent corporation); G.C.M. 39102 (Dec. 21, 1983) (following G.C.M. 37905 position that a post-merger push-up of substantially all the assets of a target corporation will not be treated as a forward triangular merger).

[161] Rev. Rul. 2001-25 could have been based solely on a substitution of assets theory. *See supra* note 95.

[162] *See* § 5.2(d). *See also* Rev. Rul. 72-405, 1972-2 C.B. 217 (merger of a target corporation into a subsidiary in exchange for stock of the subsidiary's parent, followed by the liquidation of the subsidiary into the parent is not treated as a forward triangular merger followed by a liquidation of the subsidiary; rather, it is treated as a "C" reorganization).

[163] Rev. Rul. 77-428, 1977-2 C.B. 117.

quences flow from that difference, because the forward triangular merger has a significantly looser standard for the quantity of stock that must be issued to qualify the transaction.[164]

What effect does a subsequent liquidation of the surviving corporation in the merger have on the forward and reverse merger rules? The form of a forward triangular merger can unravel based on post-acquisition events. If, as in Exhibit 5.2, the target merges into the subsidiary for the parent's stock, the subsequent liquidation of the subsidiary (as part of the overall plan of acquisition) will cause the IRS to test the entire transaction as a "C" reorganization (generally imposing a solely for voting stock requirement).[165] If the transaction fails as a "C" reorganization, it could be deemed a taxable sale of assets from the target to the subsidiary followed by a liquidation that may or may not be taxable to the target shareholders depending on whether such deemed liquidation would qualify for tax-free treatment under I.R.C. section 332. Similarly, the subsequent liquidation of the target/survivor corporation in Exhibit 5.4 (as part of the overall plan of acquisition) will undoubtedly cause the IRS to test the entire transaction as a "C" reorganization. If the transaction fails as a "C" reorganization, it will generally be deemed that the shareholders of the target sold their stock to the parent, who then caused the target corporation to liquidate tax-free under I.R.C. section 332.[166] In each case, the use of nonvoting stock consideration (on the assumption that the merger rules permit such consideration) will defeat tax-free treatment if the subsequent liquidation is part of the overall plan of acquisition. It is not necessary that the target corporation or its shareholders be a party to the plan. It is merely sufficient that the plan be pursuant to the acquiring corporation's desires and that both the merger and the liquidation take place within a relatively short time frame.[167]

Another interesting difference arises if the acquiring corporation or target corporation *merges* into its parent corporation after a forward or reverse triangular merger.[168] In the instance of an upstream merger following a forward triangular merger, the transactions are integrated and tested as a "C" reorganization. The two mergers (*that is,* the forward triangular merger and the upstream merger) could not be tested as a single merger of the target corporation into the parent corporation because the target does not merge into the parent pursuant to state law.[169] If a reverse triangular merger is followed by an upstream merger of the target into parent, the two transactions are integrated and tested as a

[164] The IRS ruling standard is 50 percent stock (including nonvoting stock) for the forward triangular merger and 80 percent voting stock for the reverse triangular merger.

[165] Rev. Rul. 72-405, 1972-2 C.B. 217.

[166] It would be problematic to respect the pre-liquidation acquisition of the target as an independent reverse triangular merger, because the acquiring corporation does not retain control of the target immediately after the transaction. Therefore, the transaction should be respected as a stock purchase prior to a liquidation. Treas. Reg. § 1.368-2(j)(3)(ii); Rev. Rul. 90-95, 1990-2 C.B. 67.

[167] *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

[168] This analysis assumes that the forward or reverse triangular merger occurs as part of the same plan as the subsequent upstream merger of acquiring of target into parent.

[169] See Rev. Rul. 70-16, 1976-1 C.B. 186; P.L.R. 8506031 (Nov. 9, 1984).

direct "A" merger of target into parent.[170] This conclusion is soundly based. If a reverse triangular merger is followed by an upstream merger, the target corporation actually merges into the acquiring corporation under state law.

§ 5.6 SINGLE ENTITY REORGANIZATIONS

(a) "E" Reorganization

An "E" reorganization is generally described as a reshuffling of the corporate structure within the confines of a single corporation. The term "recapitalization" is also used to describe an "E" reorganization. "E" reorganizations involve an exchange between the shareholders and/or creditors and the corporation. Three types of exchanges are permitted: (1) shareholders exchange their existing stock interest for another stock interest; (2) long-term creditors[171] (i.e., security holders) exchange their debt for another type of long-term debt; and (3) long-term creditors exchange their debt for stock.

An exchange of nonvoting preferred stock by a shareholder for a new class of common stock, an exchange of unsecured 10-year debentures by a holder for nonvoting common stock and/or preferred stock, and an exchange of a secured 15-year debt by a holder for an equal face amount of 10-year participating unsecured debt all qualify as tax-free exchanges to the holder.[172] An exchange of common stock (voting or nonvoting) by a shareholder for nonparticipating preferred stock (voting or nonvoting) may or may not be taxable depending on whether the preferred stock is nonqualified preferred stock.[173]

If a shareholder exchanges with a corporation any type of outstanding stock for any type of debt instrument, then the exchange is a redemption transaction and not a recapitalization. The shareholder must recognize capital gain/loss or dividend income, depending on whether the redemption rules of I.R.C. section 302(b) are satisfied.[174]

An exchange of short-term debt by a holder for any type of stock results in a taxable transaction that may give rise to a bad debt deduction.[175] The amount of the deduction is measured by the difference between the creditor's basis in the debt and the value of the stock received. Such an exchange is neither a redemption nor is it a dividend, because property was not received from the corporation

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[170] Rev. Rul. 2001-46, 2001-2 C.B. 321.

[171] *See supra* note 66.

[172] I.R.C. § 354. Nonrecognition treatment does not apply to the extent that any stock or securities are issued for interest that has accrued on securities on or after the beginning of the holder's holding period. I.R.C. § 354(a)(2)(B).

[173] I.R.C. § 354(a)(2)(C). As discussed in § 5.2(g), nonqualified preferred stock that is received in exchange for stock other than nonqualified preferred stock is taxable boot.

[174] I.R.C. § 302(b). The determination of capital or dividend treatment is based on whether and to what extent the shareholder has reduced the interest held in the corporation, after the attribution rules of I.R.C. § 318 are applied.

[175] I.R.C. § 166.

with respect to stock.[176] The exchange is not a tax-free exchange because a short-term debt rather than a long-term security was exchanged.[177]

Thus, an "E" reorganization peculiarly lends itself to an exchange pursuant to a work-out arrangement or a title 11 bankruptcy proceeding, where existing creditors exchange their debt for other debt or stock. The debtor corporation may recognize discharge of indebtedness income,[178] but the tax-free recapitalization rules apply regardless of the type of stock received by a shareholder or creditor.

Because shareholders and debt holders would like to recognize a loss on their investment, albeit capital, they may wish to avoid an exchange that qualifies as a recapitalization. Intentional avoidance of the recapitalization rules, however, is difficult. COBE[179] and COI[180] do not apply to these reorganizations and it is extremely doubtful that an "E" reorganization will fail for lack of a business purpose. In addition, it is not necessary that there be a corporate plan of reorganization or current corporate action to invoke an "E" reorganization. Even a mere conversion by a single shareholder of one class of stock into another class of stock pursuant to rights in the outstanding stock is a recapitalization.[181] Furthermore, an exchange by a debt holder for stock and nonstock consideration (or an exchange by a debt holder for a greater principal amount of debt) will not break the recapitalization and permit loss recognition.[182] The cash, other property, and excess principal amount of securities will generally be taxable as "boot," but no gain will generally result unless there is a realized gain (as opposed to a realized loss) on the exchange.[183] For example, assume debt holder D, who holds X Corporation debt with a face amount and basis of $1,000,

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[176] *See* I.R.C. § 317(a).

[177] I.R.C. section 351 cannot apply because short-term debt (*not* a security) is being transferred. *See* I.R.C. § 351(d)(2).

[178] *See* I.R.C. § 108(e)(8). For a discussion of discharge of indebtedness income, see Ch. 2.

[179] Rev. Rul. 82-34, 1982-1 C.B. 59. *See also* Prop. Reg. § 1.368-1(b); REG-106889-4 (Aug. 11, 2004).

[180] Rev. Rul. 77-415, 1977-2 C.B. 311; Rev. Rul. 77-479, 1977-2 C.B. 119. *See also* Prop. Reg. § 1.368-1(b); REG-106889-04 (Aug 11, 2004).

[181] *See* Rev. Rul. 77-238, 1977-2 C.B. 115 (the conversion of common stock into preferred stock of equal value of the same corporation, or the conversion of preferred stock into common stock of equal value of the same corporation is an "E" reorganization); Rev. Rul. 56-179, 1956-1 C.B. 187 (the conversion of first preference stock into common stock is an "E" reorganization) (in each revenue ruling assume that nonqualified preferred stock is not received in exchange for stock other than nonqualified preferred stock). If debt is exchanged for the equity of the issuer pursuant to the terms of the debt instrument (which may occur either automatically or as a result of an option to make such change), the exchange is not treated as a modification of the debt and therefore does not result in a realization event. Treas. Reg. § 1.1001-3(c)(2)(ii); Rev. Rul. 72-265, 1972-1 C.B. 222.

[182] Rev. Rul. 71-427, 1971-2 C.B. 183.

[183] I.R.C. §§ 354(a)(2); 356(d)(2)(B). *But see Bazley v. Commissioner*, 332 U.S. 737 (1947); Treas. Reg. § 1.301-1(l) (a distribution to shareholders may be treated as a dividend even if it takes place at the same time as another transaction; this is most likely to occur in the case of a recapitalization, reincorporation, or merger into a newly formed corporation that holds no property).

exchanges that debt for stock with a value of $400 and cash of $150. Although D has a realized loss of $450 on the exchange (basis ($1,000) less value of property received ($550)), a tax-free recapitalization has taken place and the loss is not recognized. D receives the cash with no tax consequences and has a basis of $850 in the X Corporation stock.[184]

Recapitalizations are often used in insolvency work-out or bankruptcy reorganization situations to permit the creditors of a corporation to assume the status of equity holders. Consider the following example. Assume that a corporation (Lossco) has $400 of outstanding securities and $100 of gross assets and Lossco has defaulted on its debts. Further, assume the liabilities constitute securities for federal income tax purposes (generally long-term indebtedness). The creditors of Lossco may assume control of the corporation as follows: the existing stock is cancelled and Lossco issues stock (that will constitute 100 percent of Lossco's issued and outstanding stock immediately after the recapitalization) in satisfaction of its indebtedness. The transaction will constitute a recapitalization under I.R.C. section 368(a)(1)(E). The creditors will not recognize gain or loss under I.R.C. section 354 on the receipt of Lossco stock in satisfaction of the outstanding Lossco indebtedness. Lossco, however, will incur $300 of discharge of indebtedness income that should be excluded from gross income under either the bankruptcy or insolvency exception as applicable, with attendant attribute reduction.[185] Aside from the discharge of indebtedness issues, the recapitalization does not implicate gain or loss at the corporate level, because the same entity continues to exist and Lossco does not transfer its assets. The transaction may also result in a limitation on Lossco's ability to use losses (such as net operating loss carryovers) under I.R.C. section 382, as discussed in greater detail in Chapter 6.

(b) "F" Reorganization

On its face, the "F" reorganization is the most innocuous of all the tax-free reorganizations: "a mere change in identity, form, or place of organization of one corporation, however effected." The Tax Act of 1982 added the phrase "one corporation" to the definition to clarify that a combination of more than one entity cannot be an "F" reorganization. Prior to that date, the courts had permitted combinations of commonly controlled corporations to meet the "F" definition;[186] one court permitted the merger of 123 corporations.[187] The IRS eventually acquiesced in this result.[188]

Since 1982, the definition of an "F" reorganization has been limited to changes undertaken by one corporation, although a second new corporation can

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[184] Basis is determined under I.R.C. § 358 (exchanged basis of $1,000 less $150 cash received).

[185] I.R.C. §§108(a), (b), (e)(8).

[186] *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968); *Performance Systems, Inc. v. Commissioner*, 501 F.2d 1338 (6th Cir. 1974).

[187] *Home Construction Corp. v. United States*, 439 F.2d 1165 (5th Cir. 1971).

[188] Rev. Rul. 75-561, 1975-2 C.B. 129, *amplified by* Rev. Rul. 78-287, 1978-2 C.B. 146, *and modified by* Rev. Rul. 78-441, 1978-2 C.B. 152. *See also* Prop. Reg. § 1.368-2(m), REG-106889-04 (Aug. 11, 2004).

be used. For example, assume a New Jersey corporation, owned by B, wants to incorporate in Delaware. A newly created Delaware corporation, wholly owned by B, can be established, and the New Jersey corporation can merge out of existence into the Delaware corporation. This is an "F" reorganization, even though two corporations are involved. However, if the Delaware corporation was a preexisting corporation with business operations, the transaction would be tested as a "D" reorganization and not as an "F" reorganization.

The definition of a "D" reorganization explicitly mandates that the former shareholders of the target corporation "control" the acquiring corporation, but there is no statutory guidance on control or COI in an "F" reorganization.[189] Because the definition postulates "a mere change," the underlying assumption in an "F" reorganization is that there will be almost a complete overlap in shareholders. Consistent with this theory, the IRS permits only a 1 percent change in shareholders,[190] although the courts have been more lenient in this regard.[191]

Frequently, an "F" reorganization is a precursor to a larger transaction, and the question arises whether the influx of new shareholders or assets or the divestiture of assets detracts from the required "mere change." The courts, as well as the IRS, have been lenient in this inquiry. In each of the seven situations below, a favorable "F" reorganization was found, where a simple change in form, identity, or place of incorporation was preceded or followed by the event described:

1. The target corporation in the "F" was acquired in an acquisitive reorganization.[192]
2. The target corporation in the "F" reorganization became the acquiring corporation in an acquisitive reorganization.[193]
3. Subsidiaries were liquidated.[194]
4. New stock was issued to investors.[195]
5. Shareholders' stock was redeemed.[196]
6. Assets were transferred to a controlled subsidiary.[197]
7. Substantial new assets were received.[198]

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[189] Recently released proposed regulations would adopt rules that would provide that COBE and COI are not requirements for an "F" reorganization. Prop. Reg. § 1.368-2(m), REG-106889-04 (Aug. 11, 2004).

[190] Rev. Rul. 66-284, 1966-2 C.B. 115, *amplified by* Rev. Rul. 78-441, 1978-2 C.B. 152.

[191] *Compare Aetna Casualty & Surety Co. v. United States*, 568 F.2d 811 (2d Cir. 1976) (61 percent continuity is sufficient) *with Spinoza, Inc. v. United States*, 375 F. Supp. 439 (S.D. Tex. 1974) (37 percent continuity is insufficient) *and Role v. Commissioner*, 70 T.C. 341 (1978) (89 percent continuity is insufficient).

[192] Rev. Rul. 69-516, 1969-2 C.B. 56.

[193] *Dunlap & Associates, Inc. v. Commissioner*, 47 T.C. 542 (1967).

[194] Rev. Rul. 58-422, 1958-2 C.B. 145, *amplified by* Rev. Rul. 66-284, 1966-2 C.B. 115, *amplified by* Rev. Rul. 78-441, 1978-2 C.B. 152.

[195] Rev. Rul. 79-250, 1979-2 C.B. 156, *modified by* Rev. Rul. 96-29, 1996-1 C.B. 50 (*see infra* text accompanying note 199); Rev. Rul. 61-156, 1961-2 C.B. 62.

[196] *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); *Casco Products Corp. v. Commissioner*, 49 T.C. 32 (1967).

[197] Rev. Rul. 79-250, 1979-2 C.B. 156.

[198] Rev. Rul. 68-349, 1968-2 C.B. 143.

Rev. Rul. 96-29 is an often-cited and very important ruling in the "F" reorganization area.[199] The ruling sets forth two fact patterns for consideration. In Situation 1, a corporation (Q) proposed to make a public offering of newly issued stock and to cause the stock to become publicly traded. As part of this offering Q would change its state of incorporation. This change was undertaken to enable Q to avail itself of the advantages of the other state's corporate laws. Absent the public offering Q would not have changed its place of incorporation. Q accomplished this change by merging into a newly formed corporation that was organized under the laws of the other state. Q then issued new shares and redeemed outstanding preferred shares. In Situation 2, the management of corporation W wanted to acquire the business of corporation Z and combine it with the business of W's subsidiary (Y) and also wanted to change the state of incorporation of W. Pursuant to this plan, Z merged into Y for W stock in a forward triangular merger. Immediately thereafter, W changed its state of incorporation by merging with and into N, a newly formed corporation that was organized in the desired state. Upon W's change in place of organization, the holders of the W stock exchanged their stock for identical N stock. The IRS ruled that in each of Situations 1 and 2, the reincorporation transaction qualified as an "F" reorganization, even though the other transactions were affected pursuant to the same plan.

Apparently, Rev. Rul. 96-29 is intended to forestall taxpayer reliance on Rev. Rul. 79-250,[200] to avoid application of the step transaction doctrine in cases involving two reorganizations, neither of which is an "F." Rev. Rul. 96-29 states that the conclusion in Rev. Rul. 79-250 (step transaction doctrine does not apply to an "F" reorganization followed by an "A" reorganization) was attributable to "the unique status of reorganizations under section 368(a)(1)(F)," and that the earlier ruling does not "reflect the application of the step transaction doctrine in other contexts."

On a more positive note, Rev. Rul. 96-29 might also be read as an IRS endorsement of the idea that an "F" reorganization takes place in isolation from tax-free or taxable transactions that precede or follow it. Thus, a change in the state of incorporation contemporaneously with such prior or subsequent transactions should not invalidate the "F" reorganization, even though the combined transaction, if viewed as a whole, might do violence to traditional notions of "a mere change in identity, form, or place of organization of one corporation." Thus, contemporaneous transactions that might not invalidate an "F" could include a sale of stock, a disposition of substantial assets, a merger into a third corporation, the creation of a holding company, the transfer of assets to a partnership, an IPO involving 90 percent new shareholders, or even a liquidation.

Efforts to qualify a transaction as an "F" reorganization are frequently motivated by the fact that the "F" reorganization imprimatur conveys benefits that are not available to any other reorganization. An "F" reorganization permits a carryback of net operating loss or capital loss incurred after the date of the reorganization to a pre-reorganization tax year. Also, in an "F" reorganiza-

[199] 1996-1C.B. 50

[200] 1979-2 C.B. 156.

tion the reorganized corporation does not close its tax year on the date of the reorganization.[201]

Recently released proposed regulations[202] define a "mere change" for purposes of an "F" reorganization to be a transfer (or deemed transfer) of assets from target corporation to acquiring corporation only if the following four requirements are satisfied:

1. all of the acquiring corporation stock, including stock issued before the transfer, is issued in respect to the target corporation stock;
2. there is no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all of the shares of the corporation;
3. target corporation completely liquidates in the transaction; and
4. acquiring corporation does not hold any property or have any tax attributes immediately before the transfer.

The proposed regulations provide that related events that precede or follow a "mere change" will not cause the transaction to fail to qualify as an "F" reorganization. Also, the proposed regulations clarify that the treatment of "mere change" as an "F" reorganization will not affect the treatment of the overall transaction. In other words, although Step Transaction Doctrine principles are suspended for purposes of qualifying the "mere change" as an "F" reorganization, this suspension will not affect the tax treatment of the overall transaction.

§ 5.7 DIVISIVE REORGANIZATIONS

(a) Overview

In a corporate division, in which one corporation is divided into two, there are potentially two levels of tax if the transaction fails to meet the requirements of I.R.C. section 355: (1) a corporate-level tax on the distribution of any appreciated property to the corporation's shareholders and (2) a shareholder-level tax (dividend or redemption) on the value of any property the shareholders receive in the distribution. A divisive reorganization or corporate division that qualifies under I.R.C. section 355 can proceed without recognition of gain or loss at the corporate or shareholder level. Because tax-free treatment is so advantageous, and because corporate divisions can give rise to tax abuse, the I.R.C. section 355 rules are strict. For that reason, taxpayers have historically requested private letter rulings from the IRS prior to undertaking I.R.C. section 355 transactions, to ensure that these transactions would qualify as tax-free. As discussed further below in § 5.7(e), recent events are certain to curtail this practice.

[201] I.R.C. § 381(b)(3); Treas. Reg. § 1.381(b)-1(a)(2). An added benefit of an "F" reorganization compared to a "D" reorganization is the ability to avoid gain where the liabilities assumed are in excess of the basis of the assets transferred. *See* Rev. Rul. 79-289, 1979-2 C.B. 145 (I.R.C. § 357 is not applicable to an "F" reorganization).

[202] Prop. Reg. § 1.368-2(m), REG-106889-04 (Aug. 11, 2004).

(b) Types of Corporate Divisions

There are three types of corporate divisions:

1. A spin-off—generally, a pro rata distribution of the stock of the controlled corporation to the existing shareholders of the distributing corporation;
2. A split-off—generally, a distribution of the stock of the controlled corporation to one or more, but not all, of the shareholders of the distributing corporation in exchange for all or part of their stock in the distributing corporation;
3. A split-up—the complete liquidation of the distributing corporation and the resulting distribution of the stock of two or more controlled corporations, pro rata or non pro rata, to the shareholders of the distributing corporation.

In common parlance, the term spin-off is often used to denote any distribution under I.R.C. section 355 and hereafter will be so used interchangeably with divisive reorganization and I.R.C. section 355 distribution.

The distribution can be pursuant to a plan of reorganization within the meaning of I.R.C. section 368(a)(1)(D) or a tax-free incorporation under I.R.C. section 351, if the controlled corporation is newly formed or assets are transferred to an existing controlled corporation. In such a case, I.R.C. section 357(c) and its potential for gain recognition will apply.[203] The spin-off, however, can also be by a mere distribution of the stock of an existing subsidiary, and thus, not a reorganization.

(c) Requirements for Tax-Free Treatment of Corporate Divisions

For a divisive reorganization to be accomplished tax-free, I.R.C. section 355 imposes the following requirements:

1. The corporation making the distribution (i.e., the distributing corporation) must have "control" of the corporation being distributed (i.e., the controlled corporation) immediately before the distribution.
2. In the distribution, the distributing corporation must distribute all of the stock and securities of the controlled corporation, or at least enough stock to constitute control as defined under I.R.C. section 368(c).
3. At the time of the distribution, the distributing and controlled corporations must each have been engaged in the active conduct of a trade or business and each must maintain the trade or business after the transaction.
4. Both the distributing and the controlled corporations must have conducted their businesses for 5 years or must have acquired the assets (or stock) of a corporation conducting such business in a nontaxable manner within the past 5 years. The distributing corporation must own the stock of the controlled corporation for 5 years, although tacking of ownership periods is permitted.
5. A COI by the historical shareholders of the distributing corporation must be present.

[203] *See supra* discussion at § 5.4(a)(iv)(E).

6. The transaction must not be a "disqualified distribution" within the meaning of section 355(d).
7. A corporate business purpose must exist for the division.
8. The transaction must not be used as a "device" to distribute the earnings and profits of the distributing corporation, the controlled corporation, or both.
9. The distribution must not be part of a plan pursuant to which one or more persons acquire directly or indirectly stock representing a 50 percent or greater interest in Distributing or Controlled.
10. The distribution must not be an intragroup distribution of stock from one member of an affiliated group to another if such distribution is part of a plan.

Although an in-depth analysis of each of these requirements is beyond the scope of this book, the salient features of some of them are discussed below.[204]

(i) Control

Immediately prior to the distribution, the distributing corporation must have control of the controlled corporation. Control is measured by the same standard used for other reorganizations—that is, the person or entity in control must own stock processing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each class of nonvoting stock of the corporation.[205]

(ii) Distribution of Control

In addition to having control immediately prior to the distribution, the distributing corporation must distribute either all of the stock and securities it holds in the controlled corporation or an amount of stock constituting control.[206] If an amount of stock constituting control (but not all of the stock held by the distributing corporation) is distributed, then it must be established to the satisfaction of the IRS that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.[207] The retention of stock as collateral for a loan or to show amicability among customers and employees is permitted.[208]

In addition, if so-called hot stock is distributed it will not be treated as stock for I.R.C. section 355 purposes and thus may be treated as a dividend to the shareholders receiving such stock and also result in gain to the distributing corporation under I.R.C. section 311(b). "Hot stock" is addressed by I.R.C. section

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[204] For a more comprehensive analysis, *see* Rev. Proc. 96-30, 1996-1 C.B. 696 (prior to its modification by Rev. Proc. 2003-48); Wessel, Prewett, D'Avino, & Pari, "Corporate Distributions Under Section 355," Practising Law Institute (2002).

[205] I.R.C. § 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115; *see supra* § 5.2(e).

[206] I.R.C. § 355(a)(1)(D).

[207] I.R.C. § 355(a)(1)(D)(ii).

[208] Rev. Rul. 75-321, 1975-2 C.B. 123; Rev. Rul. 75-469, 1975-2 C.B. 126; P.L.R. 9003050 (Oct. 26, 1989).

355(a)(3)(B), which provides that stock of a controlled corporation acquired by a distributing corporation within five years of the distribution of such stock in a transaction in which gain or loss is recognized will not be treated as stock of the controlled corporation and will instead be treated as other property. For instance, assume that Distributing has owned 90 percent of a single class of Controlled outstanding stock for ten years. Distributing purchases the remaining outstanding 10 percent of this Controlled stock from an unrelated person. At the time of the distribution, the fair market value of the 10 percent stock interest is \$100 and Distributing has an \$80 basis in that 10 percent. Assuming all of the other I.R.C. section 355 requirements are satisfied, if Distributing distributes 100 percent of the outstanding stock of Controlled pro rata to its shareholders two years after this purchase, the "old and cold" 90 percent stock interest will be distributed tax-free under I.R.C. section 355. The 10 percent "hot stock" will be treated as a distribution of property and will be treated as a \$100 dividend to the shareholders (assuming Distributing has adequate earnings and profits) and also will result in \$20 of gain to Distributing.

(iii) Active Conduct of a Trade or Business

The active trade or business requirement is the focus of I.R.C. section 355(b). It has many facets. There must be enough activity to constitute an active business in both the distributing corporation and the controlled corporation. Merely carrying on a business is not sufficient. There must be substantial management and operational endeavors with employees.[209] Collecting rent under a net lease,[210] performing investment activities such as trading for one's own account (even with 20 employees),[211] incurring expenses prior to the production of income,[212] and owning vacant or undeveloped land or the building occupied by the distributing or controlled corporation[213] are not activities that satisfy this requirement. The IRS has determined, however, that when a corporation is the general partner in a limited partnership and has officers who perform active and substantial management functions for the partnership (including significant business decision-making) and participate in the supervision, direction, and control of the partnership's employees who operate the partnership's active business, then that corporation is engaged in the active conduct of a trade or business.[214]

It is not necessary that all of the assets of the distributing or controlled corporation contribute to the active conduct of a trade or business. In fact, the IRS has permitted substantial inactive assets (even more than half) to co-exist with

[209] Rev. Rul. 86-126, 1986-2 C.B. 58; Rev. Rul. 86-125, 1986-2 C.B. 57; Rev. Rul. 73-234, 1973-1 C.B. 180; Rev. Rul. 73-237, 1973-1 C.B. 184.

[210] Rev. Rul. 68-284, 1968-1 C.B. 143; Rev. Rul. 56-512, 1956-2 C.B. 173.

[211] Treas. Reg. § 1.355-3(c), Ex. 1; Rev. Rul. 66-204, 1966-2 C.B. 113. *Cf. Wilson v. Commissioner*, 42 T.C. 914 (1964), *rev'd on other grounds*, 353 F.2d 184 (9th Cir. 1965).

[212] Rev. Rul. 57-492, 1957-2 C.B. 247.

[213] Treas. Reg. § 1.355-3(b)(2)(iv)(B); *Rafferty v. Commissioner*, 55 T.C. 490 (1970), *aff'd*, 452 F.2d 767 (1st Cir. 1971); *Bonsall v. Commissioner*, 317 F.2d 61 (2d Cir. 1963); Rev. Rul. 56-266, 1956-1 C.B. 184. *Cf. King v. Commissioner*, 458 F.2d 245 (6th Cir. 1972).

[214] *See* Rev. Rul. 92-17, 1992-1 C.B. 142, *amplified by* Rev. Rul. 2002-49, 2002-2 C.B 50 (extending Rev. Rul. 92-17 to apply to limited liability companies in certain situations).

active assets.[215] In addition, a holding company is treated as engaged in the active conduct of a trade or business if "substantially all of its assets" consist of stock or securities in one or more controlled corporations that are engaged in the active trade or business.[216]

An active trade or business is present even though there is a cross-relationship between the distributing corporation's business and that of the controlled corporation. A controlled corporation is in the active trade or business of research, mining, or sales even though its only client or product is derived from the distributing corporation, or its employees are borrowed from an affiliated sister corporation, or its existence was created by the expansion of the distributing corporation.[217]

(iv) Five-Year History

The businesses conducted by the distributing and controlled corporations must each have a 5-year history, and the distributing corporation must have owned (or be considered to have owned) the controlled corporation for 5 years. This does not mean that the distributing corporation and the controlled corporation must each have been in existence for 5 years. In fact, the controlled corporation can be formed on the day of the spin-off by the creation of a new corporation. In other words, the distributing corporation is permitted to count as part of the 5-year history the time when the business conducted by the controlled corporation was a division of the distributing corporation. Thus, if a distributing corporation, conducting business x and business y, transfers business y to a new corporation preparatory to a spin-off, the distributing corporation is deemed to own the stock of the new corporation for all of the time period that it owned the assets of the y business.

The distributing corporation can also acquire control of the controlled corporation within the 5-year period, providing control is obtained in a transaction in which no gain or loss is recognized. Similarly, "creeping control" can be obtained in a nontaxable manner. If the distributing corporation owns 60 percent of the

[215] *See* Rev. Rul. 74-79, 1974-1 C.B. 81 (one-third active); Rev. Rul. 73-44, 1973-1 C.B. 182, *clarified by* Rev. Rul. 76-54, 1976-1 C.B. 96 (less than 50 percent active); Rev. Rul. 64-102, 1964-1 C.B. 136 (less than 50 percent active); G.C.M. 36069 (Nov. 5, 1974) (no minimum percentage required). The IRS did not ordinarily rule on whether a distribution qualified under I.R.C. section 355 if the gross assets relied on to satisfy the active trade or business assets represented less than 5 percent of the corporation's assets. Rev. Proc. 96-43,1996-2 C.B. 330. The IRS changed its no-rule position with regard to the 5-percent threshold and may now issue rulings when the active trade or business assets constitute less than 5 percent of the assets. As the percentage of active trade or business assets is reduced, more pressure is placed on the "device" requirement. The device concerns are tempered by (and the risk is shifted to the taxpayer by) a required representation to the effect that the transaction is not being carried out for a device purpose. Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

[216] For this purpose, the IRS believes that "substantially all" means at least 90 percent of the corporation's gross assets. Rev. Proc. 96-30, 1996-1 C.B. 696 4.30(5).

[217] *See, e.g.*, Treas. Reg. § 1.355-3(c), Ex. 6, 7, 9 – 11; Rev. Rul. 79-394, 1979-2 C.B. 141, *amplified by* Rev. Rul. 80-181, 1980-2 C.B. 121.

controlled corporation for 5 years, it can acquire the remaining 20 percent, constituting control, in a recapitalization, an I.R.C. section 351 exchange, or some tax-free reorganizations, but not in a redemption, a "B" reorganization, or a sham transaction.[218]

The IRS has been generous in permitting the 5-year history to run from the time when the original activities of the venture were established instead of from the time when expansion takes place. If a retail store was established by a distributing corporation 20 years ago, and if the distributing corporation created a new retail store 17 years later (3 years ago) to conduct the retail operations in a different city, then the controlled corporation and its business activity would be deemed to have a 20-year (not 3-year) history. The new store may then be transferred to a newly formed controlled corporation when it has been in operation for less than five years and controlled may be distributed to its shareholders under I.R.C. section 355 provided the other I.R.C. section 355 requirements are satisfied. Moreover, the retail store will have the same 20-year history even if it was purchased by the distributing corporation 3 years ago in a taxable asset acquisition, provided the old and new stores are in the same business.[219]

(v) Continuity of Interest

To meet the COI requirement, I.R.C. section 355 requires that the pre-distribution historical shareholders of the distributing corporation maintain a COI in both the distributing and controlled corporations for a certain period of time following the distribution. It is not necessary that *all* of the historical shareholders of the distributing corporation maintain a COI in both the distributing and controlled corporations. The shareholders simply need to maintain a COI in the aggregate. For example, in many split-off situations, the shareholders receiving stock in a controlled corporation in exchange for their stock in the distributing corporation would not own any stock of the distributing corporation after the distribution. Nevertheless, provided the pre-distribution shareholders of the distributing corporation maintain at least a 50 percent COI in the controlled corporation after the split-off, the COI requirement would be satisfied with respect to the controlled corporation. In a similar manner, the pre-distribution shareholders of the distributing corporation do not need to own any stock of the controlled corporation after the split-off, provided they maintain a COI in the distributing corporation.

EXAMPLE 5.2

Parent corporation (Distributing) is owned 50 percent each by two unrelated individuals, A and B. Distributing has a 100 percent owned subsidiary (Controlled) whose assets have a value equal to 50 percent of the value of the combined corporations. Distributing distributes 100 percent of the stock of Controlled to B in exchange for B's entire interest in

[218] *See, e.g.*, Rev. Rul. 69-407, 1969-2 C.B. 50; Rev. Rul. 56-117, 1956-1 C.B. 180; Rev. Rul. 71-593, 1971-2 C.B. 181; Rev. Rul. 70-18, 1970-1 C.B. 74; Rev. Rul. 57-144, 1957-1 C.B. 123; Rev. Rul. 63-260, 1963-2 C.B. 147.

[219] Treas. Reg. §§ 1.355-3(b)(3)(ii); 1.355-3(c), Ex. 7, 8; 1.355-2(c), Ex. 1.

> Distributing. The COI requirement is satisfied because one or more of the owners of Distributing (A and B) own, in the aggregate, sufficient stock in Distributing and Controlled to establish a COI after the split-off. If B purchased the interest in Distributing shortly before the split-off, B would not count as a shareholder for purposes of COI; rather, the individual from whom B purchased the interest would be the historical shareholder. In such a case, none of the historical shareholders of Distributing would maintain COI in Controlled, and the split-off would not qualify under I.R.C. section 355.[220]

(vi) Disqualified Distribution Under I.R.C. Section 355(d)

Since 1990, a transaction otherwise qualifying as tax-free at the shareholder level will still generate a tax at the corporate level if it is a "disqualified distribution."[221] I.R.C. section 355(d) defines as "disqualified distribution" as any distribution if, immediately after that distribution: (1) any person holds disqualified stock in the distributing corporation that constitutes a 50-percent or greater interest in the corporation, or (2) any person holds disqualified stock in the controlled corporation that constitutes a 50-percent or greater interest in the corporation. Disqualified stock is defined in I.R.C. section 355(d)(3) as (1) any stock in Distributing acquired by purchase within five years of the distribution, or (2) any stock in Controlled that was either acquired by purchase within five years of the distribution, or received in the distribution (attributable to stock or securities of Distributing that were purchased within five years of the distribution).[222]

In 2000, Treasury issued final regulations under I.R.C. section 355(d) to provide guidance on the proper application of I.R.C. section 355(d).[223] For instance, the regulations provide that stock that is acquired by purchase ceases to be treated as purchased stock if the basis resulting from the purchase is eliminated. In addition, the regulations provide that certain distributions are not disqualified if the purposes of I.R.C. section 355(d) are not violated. A distribution will not violate the purposes of I.R.C. section 355(d) if the effect of the distribution neither (1) increases the ownership in Distributing or Controlled by a "disqualified person" nor (2) provides a "disqualified person" with a purchased basis in the stock of Controlled. A "disqualified person" for these purposes is a person that holds disqualified stock in Distributing or Controlled that constitutes a 50 percent or greater interest and either (1) was acquired by purchase within the 5-year period before the distribution or (2) was received in the distribution with respect to stock that the person purchased within the 5-year period before the distribution.

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220 Treas. Reg. § 1.355-2(c), Ex. 3, 4. The regulations that relax the COI standard discussed in § 5.2(d) do not apply to I.R.C. section 355 distributions.

221 Pub. L. No. 101-508, 101st Cong., 2d Sess. §11321, 104 Stat. 1388 (1990).

222 *See* I.R.C. sections 355(d)(5), (7), and (8) for the definition of "purchase" and rules regarding aggregation of shareholders, as well attribution rules regarding stock ownership.

223 T.D. 8913, 65 Fed. Reg. 79719 (Dec. 20, 2000). These regulations are generally effective for transactions occurring after December 20, 2000.

EXAMPLE 5.3

B purchases 60 percent of the stock of P corporation. Four years after B's purchase, P distributes the stock of its wholly owned subsidiary, S, to the shareholders of P, other than B, in exchange for some or all of their P stock. Those shareholders have held their stock in P for more than 5 years. Although the distribution may be tax-free under I.R.C. section 355 at the shareholder level, P recognizes gain on the appreciation in S's stock as if the stock had been sold in a taxable transaction. The result would be the same if the distribution was a pro rata spin-off to all the P shareholders including B.

(vii) Business Purpose

The requirement that a spin-off be undertaken for a real, corporate, imminent, and substantial business purpose is often the major impediment to tax-free treatment in a spin-off. There are essentially four reasons for this:

1. The case that first mandated a business purpose in a corporate reorganization arose in the context of an attempted divisive reorganization.[224] Through the years, while business purpose was eroded in other corporate reorganizations, it remained viable in spin-off cases, even if taxpayers could show that their transactions were not undertaken for tax avoidance purposes.[225]
2. Because a significant number of spin-offs were previously undertaken only with the imprimatur of a private letter ruling, and because the IRS applies strict business purpose standards to spin-offs, many proposed spin-offs were previously abandoned in the wake of the IRS's refusal to approve them. As noted below, the IRS will no longer rule on business purpose for an I.R.C. section 355 transaction.
3. Business purpose provides a backstop for the device potential inherent in spin-offs, which is discussed below.
4. Spin-off transactions after 1986 are the only way to make tax-free distributions from a corporation. The potential for abuse and "gaming" the system has resulted in a special emphasis on business purpose to thwart unwarranted distributions.

In general, the business purpose requirement will only be satisfied by a corporate business purpose as opposed to a shareholder business purpose. Treas. Reg. section 1.355-2(b)(2) provides:

A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them.

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[224] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[225] *See, e.g., Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965); *Gada v. United States*, 460 F. Supp. 859 (D. Conn. 1978).

Nevertheless, an irreconcilable disagreement between the owners of a business is a corporate business purpose. Although shareholder motives are involved, the shareholders' inability to get along has a deleterious effect on the corporation.[226]

A business purpose is most cogent when there is third-party influence that suggests, recommends, or compels a course of corporate action. Thus, influence (or, better yet, insistence) of a supplier, customer, governmental unit, lender, underwriter, merger "partner," employee, or union will be accepted as a valid business purpose.[227] Also, the desire to save state, local, and foreign (but not federal) taxes is a valid business purpose. In contrast, estate planning reasons, the desire to separate risks or isolate liabilities, or the need to achieve goals that can be achieved by other nontaxable means (short of a spin-off) will not qualify as an I.R.C. section 355 business purpose.[228]

Although, as discussed below, the IRS will no longer provide private letter rulings with respect to whether an I.R.C. section 355 distribution is being carried out for one or more corporate business purposes, Appendix A of Rev. Proc. 96-30 remains an important tool for taxpayers and practitioners in determining whether a valid business purpose exists for an I.R.C. section 355 distribution. This Appendix sets forth the particular documentation that the IRS formerly required to qualify for one of nine enumerated business purposes: (1) key employee, (2) stock offering, (3) borrowing, (4) cost savings, (5) fit and focus, (6) competition, (7) facilitating an acquisition of Distributing, (8) facilitating an acquisition by Distributing or Controlled, and (9) risk reduction. Although neither the list itself nor the required submissions for each item on the list is intended to be exclusive, it certainly provides documentation that should be gathered and analyzed with respect to determining whether a valid I.R.C. section 355 business purpose exists and can be supported for one of the specified purposes.

(viii) Device

I.R.C. section 355(a)(1)(B) provides that a corporate division must not be used "principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both." This requirement is subjective in nature and was designed to prevent shareholders from converting dividend income into capital gain at a time (1954) when dividend income was

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[226] Treas. Reg. § 1.355-2(b)(5), Ex. 2; *Coady v. Commissioner*, 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961); Rev. Proc. 96-30, App. A, § 2.05, 1996-1 C.B. 696; Rev. Rul. 82-20, 1982-1 C.B. 6; Rev. Rul. 75-337, 1975-2 C.B. 124; Rev. Rul. 69-460, 1969-2 C.B. 51; Rev. Rul. 64-102, 1964-1 C.B. 136; Rev. Rul. 56-655, 1956-2 C.B. 214.

[227] *See* Treas. Reg. § 1.355-2(b)(5), Ex. 1, 8; *Olson v. Commissioner*, 48 T.C. 855 (1967), *supplemental opinion*, 49 T.C. 84 (1967), *acq.* 1968-2 C.B. 2, 3; Rev. Rul. 88-34, 1988-1 C.B. 116; Rev. Rul. 82-131, 1982-2 C.B. 83; Rev. Rul. 82-130, 1982-2 C.B. 83; Rev. Rul. 78-383, 1978-2 C.B. 142; Rev. Rul. 77-22, 1977-1 C.B. 91; Rev. Rul. 76-527, 1976-2 C.B. 103; Rev. Rul. 72-530, 1972-2 C.B. 212; Rev. Rul. 69-460, 1969-2 C.B. 51; Rev. Rul. 68-603, 1968-2 C.B. 148; Rul. 56-450, 1956-2 C.B. 201. *See also* Rev. Proc. 96-30, App. A, §§ 2.01, 2.03, 2.06 -.08, 1996-1 C.B. 696.

[228] *See* Treas. Reg. § 1.355-2(b)(2); Rev. Proc. 96-30, App. A, § 2.04, 1996-1 C.B. 696; Rev. Rul. 89-101, 1989-2 C.B. 67; Rev. Rul. 76-187, 1976-1 C.B. 97.

taxed at 91 percent and capital gains at 20 percent. Treas. Reg. section 1.355-2(d)(2) enumerates factors that will be evidence of a device to distribute the corporate earnings and profits, and Treas. Reg. section 1.355-2(d)(3) outlines those factors that provide evidence that the transaction is not a device to distribute the corporation's earnings and profits.[229] In general, device factors will be canceled out by nondevice factors and, in practice, a strong business purpose will diminish the importance of the device requirement. As discussed below, pursuant to Rev. Proc. 2003-48 the IRS will not be issuing private letter rulings addressing the device issue.

(ix) I.R.C. Section 355(e)

I.R.C. section 355(e) generally requires the distributing corporation to recognize gain on the distribution of controlled corporation stock if the distribution is part of "a plan (or series of related transactions)" pursuant to which one or more persons acquire, directly or indirectly, 50 percent or more of the stock of either distributing or controlled. As with I.R.C. section 355(d), I.R.C. section 355(e) does not trigger a shareholder gain.

I.R.C. section 355(e) contains some rules to define what constitutes a plan. For example, I.R.C. section 355(e)(2)(B) provides a rebuttable presumption that acquisitions of 50 percent or more of the stock of either Distributing or Controlled within a 4-year period (beginning on the date that is two years before the date of the distribution) will be treated as acquisitions pursuant to a plan.

I.R.C. section 355(e) also describes specific transactions that will *not* constitute a plan. I.R.C. section 355(e)(3) provides a list of acquisitions that are not considered in determining whether an acquisition of 50 percent or more of the stock of Distributing or Controlled has occurred. In addition, I.R.C. section 355(e)(2)(C) provides that even if the distribution is pursuant to a plan to acquire 50 percent or more of the stock of Distributing or Controlled, that plan will be disregarded if, immediately after the completion of the plan, Distributing and Controlled are members of the same affiliated group. Although these exceptions provide that certain acquisitions are not treated as part of a plan, there is no statutory guidance generally defining when a plan is deemed to exist. Thus, regulations are needed to provide additional guidance addressing when a plan exists and this need has caused the flurry of regulatory activity outlined above.

The IRS issued a series of proposed and temporary regulations addressing I.R.C. section 355(e). The most recent temporary regulations were issued in 2002.[230]

Under the temporary regulations, distributing is required to test each acquisition of Distributing or Controlled stock to determine whether the acquisition is part of a plan that includes a distribution. Whether a distribution and an acquisition are part of a prohibited plan is determined based on all the facts and cir-

[229] Device factors are: pro rata distribution, liquidation after the distribution, sale of stock of either corporation after the distribution, a high level of passive assets in either corporation, and the presence of related functions between the companies. Nondevice factors are: a strong business purpose, distribution of corporate stock that is widely held, a distributee shareholder that is a domestic corporation, and a lack of earnings and profits.

[230] T.D. 8960, 67 Fed. Reg. 20632 (Apr. 26, 2002). The temporary regulations generally apply to distributions described in I.R.C. section 355 that occur after April 26, 2002.

cumstances. The temporary regulations provide numerous facts that tend to show that a distribution either is or is not part of a plan. The temporary regulations also contain seven safe harbor provisions that protect an acquisition and distribution from being considered part of a plan. Several of the safe harbor provisions are based, at least in part, on a time factor, and several focus on the elusive requirement that there be no "agreement, understanding, arrangement, or substantial negotiations" concerning transactions related to the distribution.[231]

As discussed below, Rev. Proc. 2003-48 provides that the IRS will not issue private letter rulings addressing issues arising under I.R.C. section 355(e). This appears to be an especially harsh aspect of the new no-rule policy, because I.R.C. section 355(e) is a relatively new statutory provision, and the recently issued regulations have gone through several iterations.

(x) I.R.C. Section 355(f)

I.R.C. section 355(f) provides that, except as provided in regulations (to date no such regulations have been issued), I.R.C. section 355 will not apply to a distribution of stock from one member of an affiliated group (as defined in I.R.C. section 1504(a)) to another member of that group if the distribution is part of a plan (or series of related transactions) to which I.R.C. section 355 applies.

(d) Spin-Offs and Losses

A pro rata spin-off of an existing controlled corporation with net operating losses should have no effect on those losses under I.R.C. section 382. Any net operating losses of the distributing corporation remain with the distributing corporation and are not allocated under I.R.C. section 381 to the newly created controlled corporation. In a split-up, any net operating loss of the distributing corporation disappears, unless the split-up also qualifies as a tax-free I.R.C. section 332 liquidation.[232]

(e) Rev. Proc. 2003-48 and I.R.C. Section 355 Rulings

As noted above, because of the risks associated with a disqualified I.R.C. section 355 transaction, taxpayers have historically sought private letter rulings before proceeding with such transactions.

The IRS recently issued Rev. Proc. 2003-48.[233] This revenue procedure issued under I.R.C. section 355 modifies and amplifies Rev. Proc. 96-30[234] and modifies Rev. Proc. 2003-3.[235] Principally, the revenue procedure sets forth that the IRS will not rule on:

- Whether a distribution is being carried out for one or more corporate business purposes (instead, Rev. Proc. 96-30 is modified to require the

[231] For more detail on the I.R.C. section 355(e) regulations, *see* Wessel, Prewett, D'Avino, and Pari, "Corporate Distributions Under Section 355," Practising Law Institute (2002).
[232] Rev. Rul. 77-133, 1977-1 C.B. 96, *amplified by* Rev. Rul. 56-373, 1956-2 C.B. 217.
[233] 2003-29 I.R.B. 86.
[234] Rev. Proc. 96-30, 1996-1 C.B. 696.
[235] 2003-1 C.B. 113.

taxpayer to list its business purposes and represent that the distribution is motivated by such purposes);

- Whether a distribution is used principally as a device for the distribution of the earnings and profits (instead, Rev. Proc. 96-30 is modified to require the taxpayer to represent that the transaction is not used principally as a device for the distribution of the earnings and profits); and
- Whether a distribution and an acquisition are part of a plan (or series of related transactions) under Section 355(e)(2)(A)(ii), although the IRS may rule on a related significant issue.

Business purpose and device issues are often the central focus of an inquiry into the validity of an I.R.C. section 355 transaction. Thus, in the wake of Rev. Proc. 2003-48, taxpayers will likely seek tax opinions (and potentially multiple opinions) on these subjects.

§ 5.8 INSOLVENCY REORGANIZATIONS

(a) Insolvency Reorganization Other Than "G" Reorganizations

(i) Introduction

A discussion of the fundamental case law and government pronouncements addressing insolvency reorganizations is important for two reasons. First, insolvency reorganizations may occur outside of a bankruptcy or similar case and thus not be subject to the "G" reorganization provisions. Second, this discussion also provides a helpful background to the "G" reorganization rules.[236]

(ii) Alabama Asphaltic and Southwest Consolidated

The seminal case in the area of insolvency reorganizations is *Helvering v. Alabama Asphaltic Limestone Co*.[237] In *Alabama Asphaltic*, a bankrupt corporation (Oldco) merged into a corporation (Newco) that was formed by Oldco's creditors. Pursuant to the plan, the Newco stock was issued to the creditors of Oldco and the historical shares of Oldco were cancelled. The question at issue was whether the transaction qualified as a tax-free merger under a predecessor provision to I.R.C. section 368(a)(1)(A) and whether Oldco's historical high basis in its assets carried over to Newco. The decision of whether the transaction qualified as a tax-free merger would depend on whether the COI requirement was satisfied. The IRS did not believe continuity was satisfied because the shareholders of Oldco did not receive stock (a continuing equity interest) in Newco.

The Supreme Court disagreed, stating:

> [I]t is immaterial that the transfer shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation. Plainly,

[236] For a recent in-depth discussion of the law in this area, see "Reorganizations Involving Insolvent Subsidiaries," Report of the New York State Bar Association Tax Section, reprinted in *Tax Notes* (Nov. 10, 2003).

[237] 315 U.S. 179 (1942). The "G" reorganization provisions were not at issue because the case occurred prior to the enactment of I.R.C. section 368(a)(1)(G).

> the old continuity of interest was broken. Technically that did not occur in this proceeding until the judicial sale took place. For practical purposes, however, it took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on, they had effective command over the disposition of the property. . . . When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they *stepped into the shoes* of the old stockholders. The sale "did nothing but recognize officially what had before been true in fact."[238]

Thus, the Supreme Court held that the receipt of stock of an acquiring corporation by an insolvent corporation's creditors who had taken legal action to enforce their claims, satisfied the COI requirement necessary to qualify as a tax-free merger.

In the same year that *Alabama Asphaltic* was decided, the Supreme Court also resolved another cornerstone case in the bankruptcy/insolvency reorganization area—*Helvering v. Southwest Consolidated Corporation*.[239] *For* the sake of simplicity, assume that the facts of *Southwest Consolidated* were the same as those at issue in *Alabama Asphaltic* with three exceptions: (1) Oldco did not merge into Newco pursuant to state law but merely transferred it assets to Newco and liquidated; (2) Newco transferred warrants to shareholders and some creditors in addition to the Newco stock that was transferred to Oldco's creditors; and (3) there was not a significant overlap between Oldco's historical shareholders and creditors. The Court concluded that although the transaction satisfied the COI requirement, it nevertheless failed to qualify as a tax-free reorganization. The transaction could not qualify as a tax-free merger, because Oldco did not merge into Newco. The transaction did not qualify under the predecessor provisions to the "C" reorganization, because warrants were issued, defeating the "solely for voting stock" requirement. In addition, the transaction did not qualify under the predecessor provision to the "D" reorganization because the "stockholders" of Oldco did not control Newco after the transaction. Although the Supreme Court was, under certain circumstances, willing to look to creditors as stepping into the shoes of the historical shareholders for purposes of establishing proprietary interest, it was unwilling to equate creditors with shareholders for purposes of determining whether the control requirement for a "D" reorganization was satisfied. I.R.C. section 368(a)(1)(D) requires that the *stockholders* and not the creditors of Oldco control Newco after the reorganization. Saying that creditors hold a proprietary interest is quite a different thing from concluding that a creditor is a stockholder as required by statutory language. The Court also noted that the transaction did not qualify under the predecessor to the "E" recapitalization because it was not merely a "reshuffling of a capital structure . . . of an existing corporation;"[240] the transfer of assets to another corporation made the transaction something more than just a recapitalization. Finally, the transaction did not qualify under the predecessor provision to the "F" reorganization because "a transaction which shifts the ownership of the proprietary interest in a

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[238] *Alabama Asphaltic*, 315 U.S. at 183 (emphasis added) (citations omitted).
[239] 315 U.S. 194 (1942).
[240] *Id.* at 202.

corporation is hardly 'a mere change in identity, form, or place of organization. . . .'"[241] Thus, the *Southwest Consolidated* transaction did not qualify as a tax-free reorganization.

(iii) Recapitalizations Coupled with Insolvency Reorganizations

It is interesting to consider what the tax consequences would be if a transaction similar to that in *Southwest Consolidated* was accomplished by means of a recapitalization of the target (i.e. creditors receive stock in exchange for their debts) followed by a merger of the target into a newly formed corporation (Newco). Would this form be respected and treated as an "E" recapitalization followed by an "F" reorganization? This is exactly what the IRS concluded in PLR 7821047[242] in the context of a bankruptcy reorganization.[243] In light of *Southwest Consolidated* and the Step Transaction and Substance Over Form Doctrines, this might seem a curious result. Nevertheless, the ruling seems correct in the wake of Rev. Rul. 96-29,[244] which arguably stands for the proposition that an "F" reorganization stands alone and is not affected by the Step Transaction Doctrine. [245]

Rev. Rul. 59-222[246] presents another bankruptcy two-step transaction involving a recapitalization. This ruling does not, however, address an acquisitive reorganization in the sense that a target corporation transfers its assets to

[241] *Id.* at 202-03.

[242] (Feb. 23, 1978).

[243] *See also* Rev. Rul. 69-407, 1969-2 C.B. 50; P.L.R. 8104101 (Oct. 30, 1980); P.L.R. 7938044 (June 20, 1979); P.L.R. 7819071(Feb. 13, 1978). One would wonder if it would be preferable (if possible) to have the "F" reorganization precede the "E" recapitalization to make it clear that the recapitalization results in a permanent change to the capital structure of the corporation and thus satisfies this I.R.C. section 368(a)(1)(E) requirement. *See* Rev. Rul. 69-407, 1969-2 C.B. 50; Rev. Rul. 63-260, 1963-2 C.B. 147.

[244] 1996-1 C.B. 50.

[245] The impact of recently proposed regulations (if enacted in final form as currently drafted) on this position is unclear. Prop. Reg. §§ 1.368-1(b), 1.368-2(m), REG-106889-04 (Aug. 11, 2004). On one hand, the proposed regulations and the preamble thereto provide that (generally) to qualify as an "F" reorganization all the stock of the resulting (newly formed) corporation, including stock issued before the transfer, must be issued in respect of stock of the transferring corporation. This requirement prevents a transaction that involves the introduction of new capital to the corporation as qualifying as an "F" reorganization. If stock of the newly formed corporation could not be issued for debt of the transferring corporation under this provision, one may question whether this requirement would be satisfied if stock of the newly formed corporation is issued for stock of the transferring corporation that was recently issued in a recapitalization in exchange for debt. On the other hand, the proposed regulations and the preamble thereto also provide that, consistent with Rev. Rul. 96-29, related events preceding or following the transaction or series of transactions that constitute a mere change do not cause the transaction or series of transactions to fail to qualify as an "F" reorganization. This would appear to provide that an "E" recapitalization before or after a change in identity, form, or place of reorganization should not cause such change to fail to qualify as an "F" reorganization. As noted in the preceding footnote, one must also consider whether a recapitalization that precedes an "F" reorganization results in a meaningful and permanent change to the capital structure of the corporation. The Service should clarify this issue.

[246] 1959-1 C.B. 80.

another corporation and then liquidates. Rather, in the ruling, an insolvent corporation, M, filed for bankruptcy, and an unrelated corporation, N, proposed an acquisition of M. N issued common stock to M in exchange for newly issued common stock of M, constituting all of M's outstanding stock, and the newly issued N stock was used to satisfy the outstanding debt of M. Pursuant to this plan, M emerged as a wholly owned subsidiary of N. The IRS recast the transaction and treated it as if the N debt holders first exchanged their N debt for N stock in a tax-free "E" recapitalization and then exchanged their newly received N stock for voting stock in M in a tax-free reorganization. This recast resulted in an extremely favorable result. Because N was viewed as satisfying its indebtedness with its *own* stock, under the former stock-for-debt exception, N would not realize discharge of indebtedness income on the exchange.

This ruling has also been interpreted to apply to situations in which stock of a parent corporation is used to satisfy debt of an existing subsidiary. In such a case, the transaction may be recast as if the subsidiary satisfied its outstanding indebtedness with its own stock (a potential tax-free recapitalization, provided the debts are securities) followed by parent's acquisition of the stock of the subsidiary with its own voting stock in a "B" reorganization.

Subsequent statutory and regulatory developments cast doubts on the continuing validity of Rev. Rul 59-222. First, as discussed in § 2.4(c), the stock-for-debt exception has been repealed. Second, Treasury issued regulations governing the computation of basis when parent transfers its own stock to a wholly owned subsidiary and the subsidiary uses the parent stock to buy property, pay for services, satisfy debt, and so forth. Absent these regulations, parent's zero basis in its own stock would be inherited by the subsidiary, causing subsidiary to recognize gain when it uses that stock as consideration in a later transaction. The regulations provide for proper basis adjustments when parent transfers its stock to a subsidiary and that stock is immediately used by the subsidiary to acquire property.[247] The preamble to the regulations acknowledges that the regulation applies when the parent stock is used to satisfy debt of a subsidiary.[248] In the wake of these regulations, it is unlikely that the IRS would apply a Rev. Rul. 59-222 recast when parent, in form, transfers its stock to a subsidiary and the subsidiary then uses the parent stock to satisfy its debt. Both the form and substance of the transaction are now recognized by regulatory fiat. If, however, the form of the transaction matches the Rev. Rul. 59-222 recast (i.e., a recapitalization at the subsidiary level followed by a "B" reorganization) or if a parent corporation acquires debt of the subsidiary with its own (i.e., parent) stock and then pursuant to an integrated plan immediately contributes the debt to the capital of the subsidiary, the proper federal income tax characterization of the transaction is less clear.

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[247] The regulations only apply to avoid the zero-basis issue if certain conditions are satisfied. *See* Treas. Reg. § 1.1032-2.

[248] *See* T.D. 8883, 65 Fed. Reg. 31073 (May 16, 2000) (preamble).

(iv) Norman Scott

The *Norman Scott*[249] decision is another important precedent addressing insolvency reorganizations among related parties that occur outside of the bankruptcy context.

The transaction at issue involved three corporations, Norman Scott Inc. (Acquiring), River Oaks, and Continental (Continental and River Oaks jointly referred to as the Targets). Norman and his wife owned 99 percent of the stock of each corporation.[250] The Targets were insolvent and had debts outstanding to the bank as well as to Acquiring. Norman also served as an accommodation endorser on the bank notes of River Oaks and Continental. River Oaks and Continental both merged into Acquiring and Norman and his wife received additional Acquiring stock. The issue was whether the mergers qualified as reorganizations under I.R.C. section 368(a)(1)(A) such that the net operating losses of the Targets would carryover to Acquiring pursuant to I.R.C. section 381.

The Tax Court concluded that Norman and his wife held the proprietary interest in River Oaks and Continental in their capacity as shareholders (assuming the corporations were solvent) or as creditors (assuming the corporations were insolvent) and received stock in Acquiring in the merger in that capacity. In short, the Tax Court's view was that the continuity of proprietary interest requirement was satisfied and that the transaction qualified as an "A" reorganization.

The IRS's position on the issues presented in *Norman Scott* is summarized in G.C.M. 33859 and the attached Action on Decision.[251] The IRS agreed with the Tax Court's conclusion that the mergers qualified as "A" reorganizations, but based its conclusion on different rationale, as stated in the G.C.M.

The IRS first disagreed that the mere insolvency of a corporation shifts the proprietary interest from the shareholders to the creditors. According to the G.C.M., the creditors of the insolvent corporation must take some affirmative action to assert their claims in order to effectuate such a shift. This assertion is supported by three of the four cases cited by the Tax Court on this issue.[252] In the fourth case, *Seiberling Rubber Co. v. Commissioner*,[253] an insolvent corporation transferred its assets to a new corporation. The sole shareholder and creditor of the insolvent corporation was the majority shareholder of the newly formed corporation. The Sixth Circuit held that the transaction qualified as a tax-free reorganization under a predecessor provision to I.R.C. section 368(a)(1)(D) and that it did not make a difference that the shareholder/creditor received stock of the newly formed corporation in his capacity as a creditor rather than in his capacity as a shareholder. It was enough that the control requirement was satisfied,

[249] *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967).

[250] The Tax Court concluded that River Oaks was insolvent and that Continental was probably insolvent.

[251] (June 25, 1968). The Action on Decision is dated December 7, 1967.

[252] *Norman Scott*, 48 T.C. at 604, *citing Alabama Asphaltic*, 315 U.S. 179; *Meyer v. United States*, 121 F. Supp. 898 (Ct. Cl. 1954); *Duncan v. Commissioner*, 9 T.C. 468 (1947).

[253] 169 F.2d 595 (6th Cir. 1948).

namely that persons in control of the new corporation were shareholders of the target corporation.

The G.C.M. also acknowledges that the IRS accepted the *Seiberling* decision in Rev. Rul. 54-610.[254] In that ruling, the bondholders of an insolvent corporation also owned over 80 percent of the corporation's stock. When a newly formed corporation (Newco) acquired the assets of the insolvent corporation, these bondholders/stockholders received Newco stock in satisfaction of their bonds. Citing *Seiberling*, the revenue ruling concludes that COI was satisfied and that the transaction qualified as a reorganization under a predecessor provision to I.R.C. section 368(a)(1))(C).

Based on the authorities described above, the IRS concluded in the G.C.M. that the insolvency of the *Norman Scott* Targets shifted the proprietary interests from the outstanding stock of these corporations to their outstanding indebtedness. Nevertheless, because Norman and his wife were the shareholders of the Targets and the Acquiring corporation both before and after the transactions, COI was satisfied. The fact that they received stock in Acquiring with respect to their creditor position and not their shareholder position did not alter this result.

The next issue considered in the G.C.M. was whether the mergers should be viewed as asset transfers by the Targets in an I.R.C. section 368 reorganization or merely as transfers in satisfaction of indebtedness to Acquiring. To resolve this issue both the Tax Court and the IRS needed to address the position set forth in Rev. Rul. 59-296.[255] In that ruling a parent corporation was also a creditor of its wholly owned subsidiary in an amount in excess of the fair market value of the stock of the subsidiary. The subsidiary merged upstream into its parent. The ruling concludes that because the subsidiary's property was worth less than its debt to its parent, no part of the transfer was attributable to the stock interest of the parent. The transaction was therefore neither a tax-free liquidation under I.R.C. section 332 nor a tax-free "A" reorganization.[256] Both the Tax Court and the G.C.M. concluded that the merger of an insolvent corporation into its brother corporation was distinguishable from an upstream merger of an insolvent subsidiary into its parent/creditor.[257]

[254] 1954-2 C.B. 152.

[255] 1959-2 C.B. 87, *amplified by* Rev. Rul. 2003-125, 2003-52 I.R.B. 1243.

[256] A liquidation of an insolvent corporation into its shareholder/creditor cannot qualify for tax-free treatment under I.R.C. section 332. *See* § 7.4(e) for a discussion of this issue. In addition, after the issuance of the *Norman Scott* G.C.M., the IRS issued Rev. Rul. 70-489, allowing a parent to liquidate an insolvent subsidiary (by merging it upstream) and continue to operate the subsidiary's business as a branch, without jeopardizing the position of the parent with respect to the bad debt deduction. Rev. Rul. 70-489, 1970-2 C.B. 53, *superseded by* Rev. Rul. 2003-125, 2003-52 I.R.B. 1243 (Rev. Rul. 2003-125 does not change the result of Rev. Rul. 70-489).

[257] The Tax Court and the IRS reached this conclusion for different reasons. The Tax Court distinguished Rev. Rul. 59-296 because it was based on case law under the predecessor to I.R.C. section 332, which requires a distribution *with respect to stock* if a distribution is to qualify as a tax-free I.R.C. section 332 liquidation. The IRS based its conclusion on the historical development of I.R.C. section 332 and a consistent interpretation of the liquidation provisions and I.R.C. section 368(a)(1)(A) in the context of upstream mergers.

Thus, the Tax Court and the IRS concluded that the merger could qualify as an "A" reorganization despite the fact that the acquiring corporation was a creditor of the target.[258] In fact, the Tax Court specifically noted that the taxpayer had the choice of merging the debtor corporation into the creditor corporation in an "A" reorganization or of writing off the bad debts. If the reorganization transaction is foregone and a bad debt deduction is taken, the debtor would presumably realize discharge of indebtedness income with respect to its indebtedness to the acquiring corporation subject to the exceptions under I.R.C. section 108. In addition, under the current state of the law the target corporation in the *Norman Scott* transaction would realize discharge of indebtedness income (also subject to the I.R.C. section 108 exceptions) to the extent the amount of its indebtedness to its shareholders exceeds the fair market value of the acquiring stock issued or deemed issued to such shareholders in the merger.[259]

(b) "G" Reorganization

(i) Purpose

A "G" reorganization under I.R.C. section 368(a)(1)(G) represents Congress's attempt to deal with reorganizations of insolvent corporations.[260] As will be seen, Congress was trying to facilitate this type of transaction by relaxing some of the rules while maintaining the integrity of the reorganization provisions.

(ii) Transfer of Assets

The I.R.C. provides that a "G" reorganization is one in which a corporation transfers all or part of its assets to another corporation in a "title 11 or similar case," but only if, pursuant to the plan, stock or securities of the transferee corporation are distributed in a transaction that qualifies under I.R.C. section 354,

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[258] Once again the IRS did not agree (at least in part) with the Tax Court's rationale for reaching this result. The G.C.M. criticized the Tax Court's reliance on the *Seiberling* decision to reach this result. The IRS relied on case law that treated mergers of solvent corporations into creditor corporations as tax-free reorganizations. *See, e.g., Forest Hotel Corp. v. Fly*, 112 F. Supp. 782 (S.D. Miss. 1953) (debtor corporation was acquired by creditor corporation and stock of creditor corporation was distributed to debtor's shareholders; COI maintained); *Edwards Motor Transit v. Commissioner*, 23 T.C.M. (CCH) 1968 (1964) (downstream merger of a solvent debtor corporation into its creditor subsidiary treated as an "A" reorganization, and did not result in discharge of indebtedness to the target or debtor). In *Edwards Motor Transit*, the subsidiary's assumption of the parent's obligations (including its indebtedness to the subsidiary) was respected. The IRS was somewhat skeptical of following cases such as *Edwards Motor Transit* that involve a virtually complete overlap of shareholders in the target and acquiring corporation, because in such cases it is difficult to give meaning to the shareholder's receipt of additional stock. The G.C.M. concludes, however, that if a taxpayer is able to establish a business purpose for merging commonly owned corporations, the transaction should be respected as an "A" reorganization even though the merger also extinguishes intercorporate debt.

[259] Note that a *Norman Scott* type transaction would raise distinct issues if it occurred in a consolidated return setting.

[260] Earlier attempts to address this problem can be found in now-repealed I.R.C. §§ 371, 372, and 374.

355, or 356.[261] The transfer of assets must be pursuant to a case under title 11 of the United States Code or a receivership, foreclosure, or similar proceeding in a federal or state court,[262] and must be made pursuant to a plan that has received the approval of the court. In cases in which the transferor corporation is a financial institution to which I.R.C. section 581 or 591 applies and there is a receivership, foreclosure, or similar proceeding before a federal or state agency, then that agency is considered to be a court.[263] Although either the target or the acquiring corporation can be in a title 11 or similar case for purposes of qualifying a transaction as a "G" reorganization, the most common scenario involves a bankrupt target corporation. Therefore, the various "G" reorganization issues are discussed below in the context of a bankrupt target corporation transferring its assets to a nonbankrupt acquiring corporation.

(iii) "Substantially All"

In a "G" reorganization, as in a "D" reorganization, there must be a distribution of stock or securities in accordance with the provisions of I.R.C. section 354, 355, or 356. Thus, as was discussed in conjunction with a "D" reorganization, in order for the distribution to qualify under I.R.C. section 354, the acquiring corporation must acquire substantially all of the assets of the target corporation and the target corporation must liquidate. The concept of "substantially all" does not, however, have the same meaning in a "G" reorganization as it has in other reorganizations to which it applies. For example, it would not be feasible to use the IRS's advance ruling guidelines that mandate the acquisition of 90 percent of the net assets and 70 percent of the gross assets of the target for "C" and "D" reorganizations,[264] because bankrupt corporations are often insolvent and therefore do not have net assets. The legislative history of the "G" reorganization indicates that the "substantially all" requirement should be interpreted in light of the underlying intent of the statute: to facilitate reorganizations of financially distressed corporations.[265] A general rule of thumb that has arisen out of the private letter ruling process is that the IRS will be satisfied that the substantially all requirement has been satisfied in a "G" reorganization if the acquiring corporation acquires more than 50 percent of the gross assets and more than 70 percent of the operating assets of the bankrupt target.[266]

Because the concept of COBE and its relationship to the "substantially all" requirement applies to all acquisition reorganizations, including the "G," precedent set in the context of other acquisitive reorganizations may provide some guidance on the proportion of acquired assets that must be retained by the acquiring corporation. The IRS has stated that the COBE test will be satisfied if the acquiring corporation continues a significant line of business of the target

[261] I.R.C. § 368(a)(1)(G).
[262] I.R.C. § 368(a)(3)(A).
[263] I.R.C. § 368(a)(3)(D).
[264] Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Proc. 86-42, 1986-2 C.B. 722.
[265] S. Rep. No. 1035, 96th Cong., 2d Sess. 35, at 35-36 (1980).
[266] P.L.R. 9629016 (Apr. 22, 1996); P.L.R. 9409037 (Dec. 7, 1993); P.L.R. 9335029 (June 4, 1993); P.L.R. 9313020 (Dec. 30, 1992); P.L.R. 9229039 (Apr. 23, 1992); P.L.R. 9217040 (Jan. 28, 1992).

corporation or uses a significant portion of the target corporation's assets in a business. This is further defined to mean a business that represents approximately one-third of the value of the target corporation.[267] Thus, a retention of one-third of the target corporation's assets should satisfy the "substantially all" test in a "G" reorganization.

There is, however, some uncertainty in this area because the IRS has stated that in a "G" reorganization involving a financial institution, there must be a transfer and retention of at least 50 percent of the fair market value of the target corporation's assets in order to satisfy the "significant portion of assets" test for COBE purposes.[268] This requirement contradicts the Treasury Regulations on COBE and Congressional intent that "G" reorganizations be facilitated. Indeed, this 50-percent requirement was later modified to permit satisfaction of the test if the acquiring corporation continued the historical business of the target corporation.[269] Nonetheless, this effort to make the COBE test more stringent must be considered in structuring any "G" reorganization, because it represents one of the few published positions regarding this type of reorganization.

(iv) Continuity of Interest

Congress has also stated that the doctrine of COI applies in a "G" reorganization. As the above discussion of judicial and regulatory precedents reveals, this doctrine can be particularly troublesome in a "G" reorganization, because the shareholders of the target corporation frequently are not entitled to receive any consideration for their stock when the target corporation's liabilities exceed the value of its assets. Congressional intent is that a special rule be applied to facilitate the transaction. This rule allows the target corporation's creditors to be viewed as its "proprietors" for the purpose of determining COI. The test for continuity is applied in the following manner.

The most senior class of creditor to receive *stock*, together with all equal or junior classes (including former shareholders) who receive *any* consideration in the transaction, will be treated as the proprietors of the target corporation. For example, suppose that in a "G" reorganization, the target corporation (X) transfers substantially all its assets to an acquiring corporation (Y) in return for $1,000 in cash, $1,000 in notes, and $1,000 of Y's stock. The cash and notes are distributed to the most senior creditors of X, and the Y stock is distributed to the most junior creditors of X (the former X shareholders receive nothing). For the purposes of COI, only the junior creditors will be considered proprietors: they are the "most senior" class of creditor to receive *stock* and no class below them received any consideration. Thus, there is 100 percent COI. If, on the other hand, the cash, notes, and stock were distributed ratably among all the creditors, then all would be considered proprietors and COI would be 33 percent.

This liberal approach to COI in a reorganization presents two issues: (1) it requires the creditors of the target corporation to be ranked in order of seniority

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[267] Treas. Reg. § 1.368-1(d)(5), Ex. 1.
[268] Rev. Proc. 82-23, 82-1 C.B. 474.
[269] Rev. Proc. 83-81, 83-2 C.B. 598.

and (2) it requires care in the distribution of the stock of the acquiring corporation. A misstep in either area could result in inadvertent violation of the continuity requirement.

With regard to the first issue, in the context of a "G" reorganization in which the shareholders receive some consideration (either stock or other property), the IRS has included them in the determination as to whether COI is satisfied in addition to the creditors that receive stock (and all junior classes).[270] In *Detroit-Michigan Stove Co. v. United* States,[271] the court, however, held that a bankruptcy reorganization involving the cash-out of the creditors and the receipt of 25 percent of the stock of the acquiring corporation by the bankrupt corporation's shareholders did not satisfy the COI requirement, because under the former absolute priority rule, the stock that was received was gratuitous. Given the evolution of the bankruptcy code, the continuing vitality of this decision is questionable. Nevertheless, if creditors are cashed out in the bankruptcy reorganization and shareholders are given a de minimis amount of stock, the COI requirement could continue to be problematic.

With regard to the second issue, the statutory language of I.R.C. section 368(a)(1)(G) provides there must be a distribution of stock or securities pursuant to I.R.C. section 354, 355, or 356. To satisfy this requirement, there must be a distribution of stock of the acquiring corporation with respect to stock or securities (i.e., generally long-term debt or potentially warrants) of the target corporation or a distribution of securities of the acquiring corporation with respect to securities of the target corporation.[272] Failing "G" reorganization status would render the reorganization taxable at the corporate level as well as to the stockholder and security holders, provided the transaction does not qualify for tax-free treatment pursuant to another reorganization provision or statutory exception. Because only a portion of the acquiring corporation's stock must be distributed tax-free under I.R.C. section 354, a creditor who receives stock in a transaction that qualifies as a "G" reorganization exchange for debt that is not a security (thus, an exchange to which I.R.C. section 354 does not apply) will not be protected from recognizing gain or prevented from recognizing loss. Thus, the non-security creditors will have a bad-debt loss (to the extent the value of stock is less than the claims) under I.R.C. section 166 or a capital loss on the debt's retirement under I.R.C. section 1271(a)(1). The stock received would be subject to the recapture rules under I.R.C. section 108(e)(7). However, the corporate level transfer will be tax-free under I.R.C. section 361.

[270] P.L.R. 9409037 (Dec. 7, 1993); P.L.R. 9629016 (Apr. 22, 1996).

[271] 121 F. Supp 892 (Ct. Cl. 1954).

[272] *See* P.L.R. 8503064 (Oct. 24, 1984); P.L.R. 8521083 (Feb. 27, 1985); P.L.R. 8909007 (Nov. 30, 1988) (distribution of stock to *one* person or entity who holds a security will satisfy the requirement). Despite these rulings, one should consider the risk that the distribution requirement may not be satisfied if a token amount of stock of the acquiring corporation is distributed with respect to stock of an insolvent bankrupt target corporation merely for the purpose of satisfying this requirement.

(v) Triangular "G" Reorganization

Congress also authorized the use of triangular "G" reorganizations. I.R.C. section 368(a)(2)(D) was amended to permit a forward triangular "G," which would operate in the same manner as the forward triangular merger (see Exhibit 5.2).[273] Congress added I.R.C. section 368(a)(3)(E) to permit a reverse triangular "G," similar to a reverse triangular merger (see Exhibit 5.4), with two major exceptions. First, in a reverse triangular "G," no former shareholder of the target corporation (that is, the financially distressed corporation which will be the "survivor" of the transaction) may receive any consideration in return for his or her stock. Second, the former creditors of the target corporation must exchange at least 80 percent of the fair market value of their debt solely for voting stock of the controlling (parent) corporation.[274]

(vi) Dominance of "G" Reorganization

If a transaction qualifies as both a "G" reorganization and another type of I.R.C. section 368 reorganization, or a tax-free 332 liquidation, or a tax-free I.R.C. section 351 exchange, the transaction will be considered to be a "G" reorganization only.[275] An exception to this rule is provided when the transaction in question would also be one to which I.R.C. section 357(c) applies (either a "D" reorganization or an I.R.C. section 351 transfer). In such cases, I.R.C. section 357(c) will continue to apply despite the fact that the transaction is treated as a "G" reorganization.[276] I.R.C. section 357(c)(2) provides, however, that the potential gain recognition triggered by application of I.R.C. section 357(c) does not apply to a "G" reorganization in which no former shareholder of the transferor corporation receives any consideration for his or her stock.

If possible, the debtor may prefer to structure a transaction as a recapitalization of an existing corporation under I.R.C. section 368(a)(1)(E) rather than as a "G" reorganization. Under the "E" reorganization, there is no COI requirement. Thus, if there is some concern about meeting this requirement, a recapitalization may be preferable.[277]

(vii) Tax Treatment

The tax treatment of the participants in a "G" reorganization follows the traditional rules, with certain exceptions. The target corporation will recognize no gain or loss on the assumption of its liabilities (unless I.R.C. section 357(c)

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[273] *See* P.L.R. 9544026 (Aug. 4, 1995) (transfer of substantially all of the assets of a mutual insurer to a Newco in exchange for Newco's assumption of the mutual insurer's liabilities (via an assumption reinsurance agreement) treated as a "G"/(a)(2)(D)).

[274] I.R.C. § 368(a)(3)(E). *See also* P.LR. 9229039 (Apr. 23, 1992) (merger of parent into subsidiary coupled with cancellation of worthless stock of other subsidiaries when undertaken to simplify corporate structure and facilitate administration of bankruptcy, qualifies as a "G" reorganization).

[275] I.R.C. § 368(a)(3)(C).

[276] *Id.*

[277] *See* § 5.8(a)(iii) (issues arising when recapitalizations are coupled with insolvency reorganizations).

applies) nor on the receipt of the acquiring corporation's stock or securities in exchange for its assets.[278] The acquiring corporation will recognize no gain or loss on the issuance of its stock in exchange for the target corporation's assets.[279] In general, it will also take a transferred basis in those assets,[280] but this basis, unlike the transferred basis in other reorganizations, may be subject to adjustment.[281] As with the other reorganizations, the holding period of the assets will be tacked onto the acquiring corporation's holding period.[282]

Tax treatment of the stockholders and creditors of the target corporation in the context of a "G" reorganization is more complex. If stock of the acquiring corporation is received in exchange for stock of the target corporation, then no gain or loss will be recognized by the stockholder. If stock or securities of the acquiring corporation are received in exchange for securities of the target corporation, then no gain or loss will generally be recognized by the target security holder with a few exceptions.[283] If the proprietor receives consideration for accrued interest on a security of the target corporation, this consideration will be treated as interest income.[284] This rule applies to all reorganizations, but it is more likely to occur in a "G" reorganization. Also, if the principal amount of a security received by a security holder exceeds the principal amount of the security surrendered, then the fair market value of this excess principal amount should be taxable as a capital gain, if there is a realized gain in the transaction.[285] This rule also applies to all reorganizations. If nonrecognition treatment is afforded the stockholder or security holder, then both transferred basis and tacking on of the holding period would be applicable as in other reorganizations.[286] If stock or securities are received in exchange for a nonsecurity debt, a gain or loss will be recognized by the proprietor on the exchange. The gain or loss will be based on the difference between the value of the stock exchanged and the basis of the claim.

(c) Special Provisions Applicable to Financial Institutions

Prior to the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), three special rules in the Economic Recovery Tax Act of 1981 applied to thrift institutions in financial difficulty. The first of

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[278] I.R.C. § 361(a). If, as is often the case, the "G" reorganization involves a discharge of indebtedness, I.R.C. § 108 will control the tax treatment of the target corporation.

[279] I.R.C. § 1032.

[280] I.R.C. § 362(b).

[281] I.R.C. §§ 108, 1017. *See also* Temp. Treas. Reg. §§ 1.108-7T; 1.1017-1T (attributes, including basis, are reduced due to I.R.C. sections 108 and 1017 before they are inherited by acquiring corporation).

[282] I.R.C. § 1223(2).

[283] I.R.C. § 354(a)(1).

[284] I.R.C. §§ 354(a)(2)(B); 354(a)(3)(B). *See In re Dow Corning Corp.*, 244 B.R. 678 (E.D. Mich. 1999) (involving post-petition interest; this topic is discussed further in Chapter 7).

[285] I.R.C. § 356(d)(2). In a "G" reorganization the "other property" would not be distributed to a shareholder with respect to stock and, therefore, should not be treated under I.R.C. § 356(a)(2) as equivalent to a dividend.

[286] I.R.C. §§ 358; 1223(1).

these rules, under I.R.C. section 597, provided that financial assistance payments received from the Federal Savings and Loan Insurance Corporation (FSLIC) would not be included in the recipient's income and would not reduce the basis of the recipient's assets. The second of these rules, under I.R.C. section 368(a)(3)(D), permitted financially troubled thrift institutions to enter into FSLIC-assisted acquisitions and have those acquisitions qualify as tax-free reorganizations without meeting the usual COI requirement. The third special rule, under I.R.C. section 382, prevented, in many instances, the usual limitation on net operating loss carryovers and built-in losses.[287]

Viewed together, these three special rules essentially provided troubled financial institutions with double tax benefits, by both excluding payments from income and removing the limitation from otherwise limited loss carryovers. The purpose of FIRREA—to eliminate this double benefit—was accomplished in broad terms: both the exemption from income of assistance payments and the favorable loss transfer rules were eliminated. FIRREA also gave considerable discretion to the IRS and the Treasury Department to establish the precise tax treatment of acquisitions of troubled financial institutions.

In Notice 89-102,[288] the IRS provided preliminary guidance on the manner in which the new FIRREA provisions were to be applied. This Notice was followed in May, 1992, with proposed regulations under I.R.C. section 597. The proposed regulations generally apply to the receipt of federal financial assistance by (or in connection with the acquisition of) a troubled bank or thrift institution on or after May 10, 1989 (the effective date of FIRREA). This retroactive application of the proposed regulations is, however, elective; taxpayers are permitted to choose (with some exceptions) between the provisions of the proposed regulations and those of Notice 89-102.

Both the legislative history of FIRREA and the provisions of Notice 89-102 are based on the assumption that, even with the usual limitations, the losses of an acquired troubled financial institution would be available to offset the income from the federal assistance payments. This assumption was in turn based on the assumption that the acquisition would be treated as a taxable asset purchase. Such treatment was not, however, assured by the provisions of the Notice. The proposed regulations significantly increase the number of transactions that will be characterized as taxable asset sales, and also explicitly establish a deferral mechanism designed to permit the matching of the income and losses. In other words, where the provisions of Notice 89-102 produced divergent tax consequences depending on the form of an assisted acquisition of a troubled bank, such matters of form as whether liabilities were assumed or whether assets versus stock was acquired have been largely rendered moot by the proposed regulations. Under the new deferral mechanism, the amount of income from federal assistance that must be recognized will be limited as shown in Example 5.4.

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[287] *See* Chapter 6 for a discussion of the general rules under I.R.C. § 382.

[288] 1989-2 C.B. 436.

EXAMPLE 5.4

Assume a bank (B1) has assets with an adjusted basis of $100 million and liabilities of $200 million, including deposit liabilities. Pursuant to a plan of federal assistance, B1 transfers to a second bank (B2) $120 million of its deposit liabilities and assets with an adjusted basis of $10 million. In connection with the transfer, B2 receives $115 million of federal assistance. Although the assistance goes to B2, B1 is deemed to have received it and transferred it to B2 in cash. The transaction is treated as a taxable asset sale, giving B1 a loss of $5 million ($125 million in cash and assets exchanged for the assumption of a $120 million liability). Under the deferral mechanism, B1 includes only $105 million of the federal assistance in its income (the sum of the excess of its liabilities over its assets at the beginning of the year ($100 million plus the excess of its deductions for the year over its income for the year ($5 million)). The remaining $10 million of federal assistance is placed in a deferral account for recognition in a later year.

With limited exceptions, the treatment prescribed by the proposed regulations abolishes carryover basis treatment of acquisitions of troubled financial institutions under FIRREA.

§ 5.9 SUMMARY

Common threads run through the reorganization provisions. These include business purpose, continuity of business enterprise, continuity of interest, the "solely for voting stock" requirement, and the "substantially all" requirement. Despite this commonality, these concepts can have different meanings when applied to specific reorganizations. Care must be taken in structuring a transaction to determine the precise concepts that apply. In overlap situations, careful consideration must be given to the form of reorganization that will take precedence.

As will be seen in Chapter 6, the determination of the applicable reorganization provision will be important in determining whether a corporation restructuring its debt will be able to make use of pre-reorganization losses.

CHAPTER SIX

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§ 6.1 INTRODUCTION

I.R.C. section 172 provides for the carryback and carryover of net operating losses. A corporation is, in most cases, allowed to carry over, for up to 20 years, net operating losses sustained in a particular tax year that are not carried back to prior years.[1] Beginning with tax years ending in 1976, the taxpayer can elect not

[1] I.R.C. § 172(b)(1)(A). The Taxpayer Relief Act of 1997 reduced the carryback period for net operating losses from three years to two years and extended the carryover period from 15 years to 20 years. The revised carryback and carryover periods are effective for net operating losses arising in tax years beginning after August 5, 1997. Pub. L. No. 105-34, §1082, 111 Stat. 788, 950, 105th Cong., 1st Sess. (1997). Special rules apply for REITs, specified liability losses, excess interest losses, corporate capital losses, and casualty losses of individual taxpayers. *See* I.R.C. § 172(b)(1)(B), (C), (E), (F). The length of the carryback and carryover periods has varied over the years. Most recently, the carryback period was lengthened from two years to five years for net operating losses incurred in tax years ending in 2001 and 2002. I.R.C. § 172(b)(1)(H).

to carry losses back.[2] Prior to that time, losses had to be carried back to the three preceding tax years first; if all of the loss was not used against income in prior years, it might then be carried over.

The extent to which the net operating loss can be preserved in bankruptcy and insolvency proceedings depends on the manner in which the debt is restructured. The net operating loss is generally preserved if there is no change in ownership. The forgiveness of indebtedness generally does not affect the ability of the corporation to carry over prior net operating losses.[3] The loss carryover may, however, be reduced to the extent of the discharge of debt, as discussed in Chapter 4.[4]

Special problems may arise when the debt restructuring involves the use of another corporation. When a corporation acquires another corporation in certain tax-free asset acquisitions, I.R.C. section 381 permits the acquiring corporation to inherit and use the net operating loss carryovers of the acquired corporation. Both case law and other I.R.C. sections, however, may limit the use of such acquired carryovers. Even when no new corporation is involved, a number of transactions undertaken to restructure debt can change corporate ownership and trigger the application of code provisions or judicial doctrines that limit a loss corporation's ability to use its net operating loss carryovers.

The objective of this chapter is to discuss how the net operating loss can be preserved in an internal restructuring (generally a recapitalization under I.R.C. section 368(a)(1)(E)) or a restructuring involving another corporation. The first part of the chapter, which briefly describes the provisions of I.R.C. section 381, is followed by a brief discussion of the provisions of I.R.C. section 382 that applied prior to the changes introduced by the Tax Reform Act of 1986. The balance of the chapter discusses the current Internal Revenue Code: the section 382 provisions, the general limitation of section 382(b), the section 383 limitation on the use of credit carryovers, the section 384 limitation on the use of preacquisition losses to offset built-in gains, the bankruptcy exception of I.R.C. sections 382(l)(5) and (l)(6), and the tax avoidance provisions of I.R.C. section 269. The *Libson Shops* doctrine and the numerous special rules affecting losses in the consolidated return regulations are also discussed.

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[2] I.R.C. § 172(b)(3).

[3] Rev. Rul. 58-600, 1958-2 C.B. 29.

[4] An unresolved issue deals with the extent to which the trustee can avoid elections that are otherwise irrevocable. For example, the Eighth Circuit held in 1991 that an irrevocable transfer under the I.R.C. constitutes a transfer for purposes of the Bankruptcy Code. The Eighth Circuit allowed the trustee to avoid a prior election that was made to carry over a net operating loss under I.R.C. section 172. *In re Russell,* 927 F.2d 413 (8th Cir. 1991). In a similar decision, a district court held that a chapter 7 bankruptcy trustee may avoid elections that are irrevocable under the I.R.C. These elections concerned the filing of consolidated federal returns and the relinquishment of the carryback period regarding net operating losses the debtors incurred and deducted. *In re Home American T.V.-Appliance-Audio, Inc.,* 193 B.R. 929 (D. Ariz. 1995).

§ 6.2 I.R.C. SECTION 381

(a) Introduction

I.R.C. section 381 provides that, in certain types of acquisitions of assets of a corporation by another corporation, the acquiring corporation inherits some of the tax attributes of the acquired entity. Net operating loss carryovers are one of the specified tax attributes.

(b) Qualifying Acquisitions

Only liquidations of controlled subsidiaries under I.R.C. section 332 and five types of tax-free reorganization under I.R.C. section 368(a) are subject to the tax attribute carryover rules of I.R.C. section 381(a).[5]

Unless some other statute provides otherwise, the net operating loss and other tax attributes of the acquiring corporation are not affected by the acquisition. As a general rule, if a loss is expected after a reorganization, the corporation with the greatest carryback potential (i.e., the corporation with the most income in prior periods for which a carryback of a subsequently generated net operating loss would result in the greatest refund) should be the surviving corporation in the reorganization.

(i) Liquidation of Controlled Subsidiary

I.R.C. section 381(a)(1) permits the carryover of tax attributes, including net operating losses, in a liquidation under I.R.C. section 332. The tax basis of the subsidiary's assets also carries over to the parent.[6] Under former I.R.C. section 334(b)(2), if basis was determined by reference to the cost of the subsidiary's stock, tax attributes were not carried over. I.R.C. section 334(b)(2) was repealed by I.R.C. section 338, which was added by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Thus, for transactions occurring after September 1, 1982, the only way to give the acquiring corporation a step-up in basis is to invoke I.R.C. section 338.[7]

Section 332 applies to a "receipt by a corporation of property. . . ." Thus, if the subsidiary is insolvent and its shareholders receive nothing in the liquida-

[5] The use of other means to preserve the net operating loss was limited by the Bankruptcy Tax Act of 1980. Prior to that Act, a Chapter X reorganization was granted special tax treatment under I.R.C. § 371. The basis of the old corporation carried over to the acquiring corporation and no gain was reported for the debt discharged. The basis reduction provision that was required in bankruptcy cases not qualifying under I.R.C. § 371 did not apply. Because there was no provision in I.R.C. § 371 for the net operating loss carryover, however, it was not clear that net operating losses could be carried over. The Bankruptcy Tax Act of 1980 repealed I.R.C. § 371. *See* David R. Tillinghast & Stephen D. Gardner, Acquisitive Reorganization and Chapters X and XI of the Bankruptcy Act, 26 *Tax L. Rev.* 663 (1971). Transfers of property to a controlled corporation under I.R.C. section 351 were also used to preserve the net operating loss, before the Bankruptcy Tax Act of 1980.

[6] I.R.C. § 334(b)(1).

[7] *See infra* §§ 7.13-22.

tion, I.R.C. section 332 is not applicable because there is no receipt by a corporation of property distributed in complete liquidation of another corporation.[8] I.R.C. section 332 treatment has even been denied where the preferred (but not the common) shareholders received property in the liquidation of a subsidiary.[9] An insolvent subsidiary cannot be made solvent, prior to its liquidation, by having its parent cancel a debt due from the subsidiary.[10] The liquidation of an insolvent subsidiary, however, entitles its parent to claim a bad debt deduction under I.R.C. section 166 and possibly a worthless stock deduction under I.R.C. section 165(g)(3).[11]

Three conditions must be met for a liquidation to qualify under I.R.C. section 332:

1. The parent corporation must own at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent

[8] Treas. Reg. § 1.332-2(b). *See also Commissioner v. Spaulding Bakeries Inc.,* 252 F.2d 693 (2d Cir. 1958); Rev. Rul. 68-359, 1968-2 C.B. 161; Rev. Rul. 59-296, 1959-2 C.B. 59, *amplified by* Rev. Rul. 2003-125, 2003-52 I.R.B. 1. The inapplicability of I.R.C. section 332 will not only prevent attribute carryover, but may also trigger recognition of excess loss accounts in the consolidated group context. *But see* Treas. Reg. § 1.1502-19(b)(2) (exception to excess loss account recognition for nonrecognition and deferral transactions). In contrast, in *Norman Scott, Inc. v. Commissioner,* 48 T.C. 598 (1967), the merger of an insolvent brother subsidiary into its sister subsidiary qualified as an I.R.C. section 368(a)(1)(A) reorganization, even though the brother corporation's shareholders were creditors of the brother corporation and therefore received the merger consideration as creditors rather than as shareholders. *See supra* § 5.8(a)(iv).

[9] *H. K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986). *See also Commissioner v. Spaulding Bakeries Inc.*, 252 F.2d 693 (2d Cir. 1958).

[10] Rev. Rul. 68-602, 1968-2 C.B. 135.

[11] Rev. Rul. 70-489, 1970-2 C.B. 53, *superseded by* Rev. Rul. 2003-125, 2003-52 I.R.B. 1. *See also* Private Letter Ruling 9425024 (Mar. 25, 1994) (allowing deductions under I.R.C. sections 165(g)(3) and 166). The liquidation of an insolvent subsidiary may be affected by I.R.C. section 1271, which provides: "Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor." On its face, I.R.C. section 1271 requires capital (as opposed to ordinary) loss treatment. Cases interpreting I.R.C. sections 166 and 1271 (or their predecessors) suggest that an I.R.C. section 166 deduction is available to a corporate creditor (notwithstanding I.R.C. section 1271), provided the creditor charges off the bad debt before the liquidation and that the charge-off was not in contemplation of the liquidation. *See, e.g., Mitchell v. Commissioner*, 187 F.2d 706 (2d Cir. 1951), *rev'g* 13 T.C. 368 (1949) (not allowing bad debt deduction if taxpayer first sold debt and then attempted to charge it off and take the deduction; allowing bad debt deduction if the charge-off preceded and was "independent of the sale"). *See also Levine v. Commissioner*, 31 T.C. 1121 (1959), *acq.*, 1959-2 C.B. 5 (bad debt deduction allowed when loans written off in June 1947 were sold in September 1947); *IDI Management, Inc. v. Commissioner*, 36 T.C.M. (CCH) 1482 (1977) ("If partial worthlessness is factually established as happening prior to a sale or exchange, two identifiable tax events have occurred. . . . This is true even where both such events occur within the same taxable year."); cf. *Von Hoffman Corp. v. Commissioner*, 253 F.2d 828 (8th Cir. 1958) (bad debt deduction not allowed when loans determined to be uncollectible were not written off, and later, sold). *See also* § 9.3(g) regarding the stock disallowance rule of the consolidated return regulations.

of the total value of all other classes of stock,[12] excluding certain preferred stock.[13] The 80-percent requirement can be met by an acquisition immediately before the liquidation[14] but it cannot be satisfied by a redemption before the liquidation.[15] The intentional avoidance of I.R.C. section 332, in order to recognize a loss, by a sale of subsidiary stock to reduce the parent's holdings below 80 percent is generally permitted.[16]

2. There must be a complete liquidation of all of the subsidiary's assets in accordance with a plan of liquidation. I.R.C. section 332(b)(2) provides that a formal plan need not be adopted if there is a shareholders' resolution authorizing the distribution of all the corporation's assets in complete redemption of all stock. Thus, if there is an informal adoption of a plan of liquidation, I.R.C. section 332 may be satisfied if all property is transferred within a tax year.[17]
3. The plan of liquidation must provide for the transfer of all property within three years after the close of the tax year in which the first distribution is made.[18] If the property is not distributed within this time frame, or if other provisions of I.R.C. section 332 subsequently prevent the distribution from qualifying, I.R.C. section 332 will not apply to any distribution.

(ii) Reorganizations

I.R.C. section 381(a)(2) requires the carryover of tax attributes, including net operating losses, if property of one corporation is transferred pursuant to a plan or reorganization, solely for stock and securities in another corporation (I.R.C. section 361), provided the transfer is in connection with one of the following tax-

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[12] I.R.C. § 332(b)(1). The aggregation rules of the consolidated return regulations can be used to combine stock owned by members of a consolidated group. *See* Treas. Reg. § 1.1502-34. *Cf.* I.R.C. § 337(c) (providing that the consolidated return rules do not apply to the distributing corporation). This dichotomy was designed to prevent so-called "mirror" transactions. For a more complete discussion of this issue, see Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 10.22[3] (7th ed. 2002).

[13] Under I.R.C. section 1504(a)(4), excluded preferred stock is (a) nonvoting, (b) limited and preferred as to dividends and does not participate in growth to a significant extent, (c) has redemption and liquidation rights that do not exceed the issue price of such stock (except for a reasonable liquidation premium), *and* (d) is not convertible into another class of stock.

[14] Rev. Rul. 75-521, 1975-2 C.B. 120.

[15] Rev. Rul. 70-106, 1970-1 C.B. 70. *Cf. George L. Riggs, Inc. v. Commissioner*, 64 T.C. 474 (1975), *acq.* 1976-2 C.B. 2.

[16] *See Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956) (sale and gift recognized, allowing parent to recognize loss on liquidation); *Commissioner v. Day & Zimmerman, Inc.*, 151 F.2d 517 (3d Cir. 1945) (sale recognized even though it was to the corporate treasurer); Field Service Advice 200148004 (July 11, 2001). *But see Associated Wholesale Grocers v. United States*, 927 F. 2d 1517 (10th Cir. 1991) (applying step transaction doctrine to impose section 332 treatment and deny loss on liquidation).

[17] I.R.C. § 332(b)(2).

[18] I.R.C. § 332(b)(3). *See* Rev. Rul. 71-326, 1971-2 C.B. 177.

free reorganizations described in I.R.C. section 368(a)(1): "A," "C," "D," "F," or "G."[19] I.R.C. section 381 does not apply to "B," divisive "D," "E," and divisive "G" reorganizations, nor does it apply to I.R.C. section 351 transfers.[20] There is generally no carryover of attributes in these transactions.[21]

(c) Tax Attributes

As noted above, I.R.C. section 381 provides for the carryover of tax attributes of the acquired corporation in certain tax-free reorganizations. Among the tax attributes discussed in I.R.C. section 381(c) are net operating losses, earnings and profits, capital loss carryovers, investment credits, inventory and depreciation methods, and accounting methods. Because the I.R.C. lists the items that can be carried over, it might be assumed that unless an item is listed, it cannot be carried over. Legislative history, however, indicates that I.R.C. section 381 "is not intended to affect the carryover treatment of an item or tax attribute not specified in the section or the carryover treatment of items or tax attributes in corporate transactions not described in [I.R.C. section 381(a)]."[22] Thus, unlisted attributes that are similar in nature to those listed may be carried over. Bittker and Eustice suggest that items and transactions not listed may also be controlled by pre-1954 case law.[23]

(d) Transfer of Net Operating Losses

An inherited net operating loss must be used by the corporation that acquires the assets of a loss corporation. Thus, historically, if the acquired (loss) corporation in a "C" reorganization elected to continue some limited form of business and not liquidate, it would not use any prior net operating loss, because the loss would have passed to the acquiring corporation.[24] This problem has been largely eviscerated for transactions occurring after 1984, however, because such transactions must generally include a liquidation of the acquired corporation in

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[19] These reorganizations are described in detail in Chapter 5, *supra*.

[20] Unless otherwise noted, references to "G" reorganizations are to acquisitive "G" reorganizations. Divisive "G" reorganizations are rare.

[21] Of course the proper characterization of the transaction can be difficult. *See, e.g.*, 1993 F.S.A. Lexis 93 (Jan. 15, 1993) (release in 1998) (agent originally argued transaction was an "E"; IRS concluded that the reorganized corporation was the same corporation that generated the net operating losses and, therefore, did not restrict the use of the net operating losses; IRS also advised the acquired company that the loss could not be disallowed or limited by (1) I.R.C. section 269; (2) *Libson Shops Inc. v. Koehler*, 353 U.S. 382 (1957); (3) I.R.C. section 382(a); or (4) the separate return limitation year rules). *But see* Treas. Reg. §§ 1.312-10; 1.312-11 (addressing adjustments and allocation of earnings and profits in divisive "D" reorganizations, certain 351 transfers, and other transactions).

[22] S. Rep. No. 1622, 83d Cong., 2d Sess. 277 (1954). *See also* Treas. Reg. § 1.381(a)-1(b)(3).

[23] Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.24 (7th ed. 2002). Although foreign tax credit carryovers are not listed in I.R.C. section 381(c), those carryovers are governed by I.R.C. section 383. *See infra* § 6.5.

[24] Rev. Rul. 73-552, 1973-2 C.B. 116, *obsoleted by* Rev. Rul. 95-71, 1995-2 C.B. 323.

order to qualify as a "C" reorganization.[25] Similarly, this problem should not arise in a "G" reorganization, because one of the "G" reorganization requirements is that the acquired corporation liquidate.

Treas. Reg. section 1.381(b)-1(b)(1) indicates that the net operating loss will generally pass to the acquiring corporation when the transfer is complete. The tax year of the transferor corporation will also generally end on this date. An alternate date—the date on which substantially all of the assets are transferred—may be used if the acquired corporation ceases operating except for those functions related to winding up its affairs.[26] To use this alternate date, the acquired and acquiring corporations both must file written statements with the IRS.[27]

The net operating loss of the acquired corporation is carried to the first tax year of the acquiring corporation that ends after the date of the transfer. I.R.C. section 381 limits the amount of net operating loss that can be used in the year of transfer to the ratio of the remaining days until the end of the acquiring corporation's tax year to 365 days. This provision is designed to prohibit the acquiring corporation from offsetting income earned prior to the acquisition against the acquired net operating loss. The above formula must be used even though the income of the acquiring corporation may not be earned evenly throughout the year. Any net operating loss disallowed in the year of acquisition due to this restriction may be used in future years. The transfer of a net operating loss will usually result in the use of two years of the carryover period. The short tax year of the acquired corporation that ends on the date of transfer counts as one, and the tax year to which the net operating loss is transferred counts as another.[28]

An acquired net operating loss can generally only be applied against postacquisition income of the acquiring corporation. The acquiring corporation may, however, offset postacquisition losses against its own preacquisition income. Postacquisition operating losses of the acquiring corporation, however, generally may not be carried back against preacquisition income of the acquired corporation.[29] The net operating carryback is allowed in a "B" and an "E," because there has been no movement of assets at the corporate level. A carryback is also permitted in an "F" reorganization, which may include an asset transfer, because this reorganization only involves a mere change of identity, form, or place of organization.

(e) Limitations on Carryover of Net Operating Losses

Although I.R.C. section 381 provides for the carryover of net operating losses and other tax attributes, as noted in the introduction to this chapter, other I.R.C.

[25] *See supra* § 5.4(a)(ii)(C) (discussion of liquidation requirement in a "C" reorganization).
[26] Treas. Reg. § 1.381(b)-1(b)(2).
[27] Treas. Reg. § 1.381(b)-1(b)(3).
[28] Treas. Reg. § 1.381(c)(1)-1(e)(3).
[29] I.R.C. § 381(b)(3). Such a carryback was allowed in *Bercy Industries v. Commissioner*, 640 F.2d 1058 (9th Cir. 1981), but this decision has been criticized by commentators. *See, e.g.*, Brown, Berkowitz, and Lynch, Three Tests Must Be Met before an Acquired Corporation's NOL Can Be Deducted, 31 *Tax'n for Acct*. 286, at 287 (1983).

sections and case law may limit carryover. Listed below is a summary of these limitations:

- **Section 382 Limitation**. I.R.C. section 382(b) limits the amount of income that can be offset by loss carryovers each year to an amount equal to the value of the old loss corporation multiplied by the federal long-term tax-exempt rate.
- **Section 383 Limitation**. I.R.C. section 383 limits the carryover of certain excess credits and net capital losses.
- **Section 384 Limitation**. I.R.C. section 384 restricts a corporation from offsetting its built-in gains with pre-acquisition losses of another corporation.
- **Bankruptcy Exception**. I.R.C. sections 382(l)(5) and (l)(6) contain special provisions for corporations in bankruptcy.
- **Tax Avoidance**. I.R.C. section 269 may be used by the IRS to disallow any deduction, credit, or other allowance when the principal purpose of certain acquisitions is to avoid tax.
- ***Libson Shops* Doctrine**. This doctrine prohibits the carryover of loss from the loss corporation to profits of different businesses.
- **CERT Rules**. I.R.C. section 172(b)(1)(E) limits carrybacks of certain losses attributable to a corporate equity reduction transaction.
- **Consolidated Returns**. The Treasury Regulations under I.R.C. section 1502 contain a number of restrictions on the use of net operating losses.

§ 6.3 RESTRUCTURING UNDER PRIOR I.R.C. SECTION 382

(a) Introduction

Prior to the Tax Reform Act of 1986, restructuring of the debt and equity of a troubled corporation that did not involve a change in ownership generally did not affect the future use of net operating losses. In selecting the nature of the restructuring, however, the debtor needed to be aware of areas where problems could develop. In particular, if the restructuring came under the provisions of I.R.C. section 382, net operating loss carryovers could be lost. In general, old I.R.C. section 382(a) eliminated the carryover if, through the purchase of stock, the ten largest shareholders of the loss corporation increased their ownership by 50 percent or more within a two-year period, and the loss corporation's old trade or business was abandoned. Old I.R.C. section 382(b) reduced the carryover if, in a tax-free reorganization, the shareholders of the old loss corporation received less than 20 percent of the stock of the reorganized corporation.

(b) Old I.R.C. Section 382(a)

Old I.R.C. section 382(a) applied only to purchases of stock from unrelated parties. Generally, stock was considered purchased if its basis in the hands of the acquirer was determined by reference to cost, and if it was acquired from an

unrelated party. Thus, acquisition of stock by gift, bequest, or nontaxable exchange (such as in a reorganization under I.R.C. section 368(a)(1)) was not a purchase. Exchanges of bonds, debentures, or other debts evidenced by securities for stock in internal restructuring normally qualified as a nontaxable recapitalization under old I.R.C. section 382(a), and were therefore not purchases within the meaning of the provision. Stock received in satisfaction of trade payables, however, was considered purchased stock.[30]

This difference in treatment (between debts evidenced by securities and other debts) gave rise to a number of cases construing the meaning of "security." Courts generally limited the definition of securities to long-term obligations, excluding short-term notes. The line between "short-term" and "long-term" continues to be hazy, however. Some courts consider five-year notes securities; others require maturities of at least ten years.

The leading case in this area is a 1954 case in which the Tax Court addressed whether notes are securities for purposes of applying a 1939 code provision (old I.R.C. section 112(b)(5)) that was the predecessor of I.R.C. section 351. The court stated:

> The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an over-all evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc. It is not necessary for the debt obligation to be the equivalent of stock since section 112(b)(6) specifically includes both "stock" and "securities."[31]

Bonds payable from three to ten years (averaging $6\frac{1}{2}$ years) have been classified as "securities" for recapitalization purposes by the IRS.[32] Cases have defined the term "securities" to include bonds payable serially with a maximum maturity date of seven years,[33] six-year bonds,[34] and ten-year promissory notes.[35] A number of cases have held that debt obligations maturing in less than five years do not qualify as "securities."[36]

Once it was determined that the restructuring involved a purchase of stock within the meaning of the statute, old I.R.C. section 382 would cause the net operating loss carryover to be lost unless the restructured corporation could

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[30] Prior to the Bankruptcy Tax Act of 1980, I.R.C. section 351 could be used to give such trade creditors tax-free treatment. This option was eliminated by the 1980 Act. I.R.C. § 351(e)(2).

[31] *Camp Wolter Enterprises v. Commissioner*, 22 T.C. 737, 751 (1954), *aff'd*, 230 F.2d 555 (5th Cir. 1956).

[32] Rev. Rul. 59-98, 1959-1 C.B. 76.

[33] *Helvering v. Watts*, 296 U.S. 387 (1935).

[34] *Commissioner v. Freund*, 98 F.2d 201 (3d Cir. 1938).

[35] *Burnham v. Commissioner*, 86 F.2d 776 (7th Cir. 1936).

[36] *Pacific Public Service Co. v. Commissioner*, 154 F.2d 713 (9th Cir. 1946) (unsecured demand notes); *Neville Coke & Chemical Co. v. Commissioner*, 148 F.2d 599 (3d Cir. 1945) (3, 4, and 5 years); *L. & E. Stirn, Inc. v. Commissioner*, 107 F.2d 390 (2d Cir. 1939) (2 ½ years); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932) (14 months).

demonstrate that it had avoided a prohibited ownership change or that it had not abandoned the loss corporation's old trade or business. If there was a prohibited change in ownership and the trade or business test was not satisfied, then the net operating loss carryover was lost. A prohibited change in ownership was one in which the ten largest shareholders of the loss corporation increased their ownership by 50 percent or more through stock purchases within the previous two taxable years. The total percent increase need not have occurred in a single transaction.

(c) Old I.R.C. Section 382(b)

As noted earlier in the chapter, I.R.C. section 381 permits a surviving corporation in certain tax-free reorganizations to inherit specified tax attributes (including net operating loss carryovers) of an acquired corporation. Old I.R.C. section 382(b) limited the ability of the surviving corporation to inherit net operating loss carryovers by reducing them if the stockholders of the loss corporation did not own at least 20 percent of the fair market value of the outstanding stock of the reorganized corporation immediately after the reorganization.

The 20 percent ownership had to exist immediately after the reorganization and had to result from the ownership of stock in the loss corporation immediately before the reorganization. Thus, if a stockholder of the loss corporation also owned stock in the acquiring corporation prior to the acquisition, such stock was not considered owned by stockholders of the loss corporation in meeting the 20 percent requirement. Generally, a later sale of the stock did not affect the carryover, but a contractual agreement made prior to the reorganization to sell the stock acquired in the reorganization would have had a negative effect on the carryover.

The amount of reduction required by old I.R.C. section 382(b)(1) was determined by first calculating the percent of the fair market value of the acquiring corporation's outstanding stock owned by the loss corporation shareholders immediately after the reorganization. If the percent was greater than or equal to 20, no reduction was required. If the percentage was less than 20, the net operating loss was reduced by a percentage equal to five times the difference between the percent ownership and 20 percent. Thus, if the shareholders of a loss corporation received 12 percent of the stock of an acquiring corporation in a qualifying reorganization, 60 percent of the loss corporation's loss survived (100 - 5 (20 -12)).

§ 6.4 CURRENT I.R.C. SECTION 382

(a) Introduction

The Tax Reform Act of 1986 significantly altered I.R.C. section 382 and the manner in which companies can use net operating losses. Where old I.R.C. section 382 limited the amount of the net operating loss that survived a change in ownership, new section 382 leaves the amount intact and limits instead the amount of income generated by the new entity against which the loss can be used.

(b) Overview

(i) Section 382 Limitation

The 1986 Act version of I.R.C. section 382 introduced an annual "section 382 limitation," which is designed to minimize the effect of tax considerations on the acquisition of loss corporations. Other provisions of current I.R.C. section 382 are not necessarily consistent with the statute's stated objectives of reducing the role of tax considerations in acquisitions and promoting certainty. For example, the rules reduce carryovers where one-third or more of the loss corporation's assets are investment assets, and they completely eliminate carryovers where there is no "continuity of business enterprise." The limitation permits loss carryovers to offset an amount of income equal to a hypothetical stream of income that would have been realized had the loss corporation sold its assets at fair market value and reinvested the proceeds in high-grade tax-exempt securities. The law is considerably complicated by further conditions for loss survival, the coverage of built-in losses, special rules relating to ownership changes, and exceptions for bankrupt corporations.

The section 382 loss limitation provisions are relevant only in the event of a change in ownership of a loss corporation. Where old I.R.C. section 382 provided separate rules, depending on whether the ownership change resulted from a taxable purchase of stock or from a tax-free reorganization, new section 382 generally provides a single regime triggered by an "ownership change." In general, an ownership change is a change of more than 50 percentage points in ownership of the value of stock of the loss corporation within a three-year period. A loss corporation is defined in I.R.C. section 382(k)(1) as a corporation entitled to use a net operating loss carryover, a current net operating loss, or a built-in loss.

The statute provides that a change in ownership can occur either as a result of an owner shift involving a 5-percent shareholder or an equity structure shift. Generally, owner shifts involve stock acquisitions and equity structure shifts involve statutory reorganizations. The two overlap, however, and, apart from effective dates, the distinction has little practical significance.

A net operating loss that arises before a change in ownership can be used in any period after the change, subject to the annual section 382 limitation. The ability of a loss corporation acquired by taxable purchase to preserve net operating losses simply by continuing its historical business is eliminated. The myriad issues that arise in connection with determining whether a loss corporation has undergone an ownership change are discussed in § 6.4(d).

The section 382 limitation generally restricts the amount of income against which prechange net operating losses can be applied in any post-change taxable year to the product to the fair market value of the stock of the loss corporation[37] immediately before the ownership change and the "long-term tax-exempt rate." Any net operating loss limitation not used because of insufficient eligible taxable income in a given year is added to the section 382 limitation of a subsequent year.

[37] I.R.C. section 382(k)(2) defines "old loss corporation" as any corporation that was a loss corporation before an "ownership change."

(ii) Value of the Loss Corporation

The fair market value of the loss corporation is thus one of the key factors in determining the use of net operating losses. With respect to publicly traded companies, the price at which the stock is trading on an established exchange, or other applicable register, is generally presumed to be an accurate reflection of the fair market value of a corporation's stock. In support of this presumption, many cases hold that stock quotations are the best evidence of fair market value.[38] Nevertheless, as noted in *Amerada Hess Corp. v. Commissioner*,[39] *Moore-McCormack Lines, Inc. v. Commissioner*,[40] and Technical Advice Memorandum 9332004,[41] there are instances in which an exception to the general rule is appropriate in order to ascertain the true value of a corporation. In particular, as noted in *Amerada*, "[w]here the market exhibits such peculiarities as cast doubt upon the validity of that assumption, the market price must be either adjusted or discarded in favor of some other measuring device. . . ."[42]

In support for valuing the corporation's stock at an amount different from the stock trading price on the NYSE, the court said in *Moore-McCormack*:

> While we are quick to recognize the persuasive importance of stock exchange prices in a stock valuation case, . . . nonetheless, we are convinced that we must carefully consider all of the evidence in the record which indicates the true fair market value for the 300,000 shares here involved. . . .
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> * * * *
>
> Of paramount importance in our rejection of the mean stock market trading price as determinative of value here is the fact that [we are valuing] a lump, a block, an integrated package or bundle of rights representing ownership of 13 percent of a large and successful corporation. We must not think in terms of 300,000 individual shares of stock at so many dollars per share, but in terms of the overall dollar value of ownership of 13 percent of Moore-McCormack Lines, Inc., with the shares of stock meaningful not as something which can be converted to cash but merely as the formal evidence of ownership of the 13 percent. . . .[43]

In this case, the court noted that it was not unreasonable under the circumstances that the per share value resulting from the purchase price exceed the weighted average stock exchange price. Moreover, Congress recognized the fact that the price at which loss corporation stock changes hands in an arm's-length transaction would be evidence of the value of the stock, although not necessarily conclusive evidence.[44]

In Technical Advice Memorandum 9332004, the IRS supported the taxpayer's contention that the stock trading price was not representative of the value of the loss corporation. Consistent with comments contained in the legislative history to I.R.C. section 382, the IRS agreed that the ownership of the stock

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[38] *See, e.g., W.T. Grant Co. v. Duggan*, 94 F.2d 859 (2d Cir. 1938); *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3d Cir. 1937).
[39] 517 F.2d 75 (3d Cir. 1975).
[40] 44 T.C. 745 (1965).
[41] (Apr. 30, 1993).
[42] *Amerada*, 517 F.2d at 83.
[43] *Moore-McCormack*, 44 T.C. at 759-60.
[44] H.R. Rep. No. 841, 99th Cong., 2d Sess., at II-187 (1986).

could, in certain circumstances, give rise to a control premium. The IRS concluded that the value of the loss corporation's stock may be "determined using evidence and methods through which it is concluded that its value was different than the amount determined" by reference to NYSE trading price. The reference to the legislative history by the IRS can be reconciled with Treas. Reg. section 1.382-2(a)(3)(i) (which provides that for purposes of determining ownership percentage, each share of outstanding stock that has the same material terms is treated as having the same value) by recognizing that in TAM 9332004, the IRS and the taxpayer were determining the total value of the loss corporation's stock as opposed to an individual shareholder's ownership percentage.

(A) Options

Another issue is whether options and similar interests should be included in determining stock value. I.R.C. Section 382(k)(6)(B) gives the Secretary the power to "prescribe such regulations as may be necessary to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock. . . ." The legislative history to I.R.C. section 382 provides that such regulations may treat options and similar interests as stock for purposes of determining the value of the loss corporation.[45] To date, such regulations under I.R.C. section 382(k)(6)(B) have not been released. Treas. Reg. section 1.382-2T(h)(4)(vii)(C) states, however, that whether an option was deemed exercised in determining whether an ownership change occurred[46] shall have no impact on the determination of the value of the old loss corporation for the computation of the limitation.

In TAM 9332004, the IRS noted that to the extent warrants for a loss corporation's stock have value, that value derives from the potential they offer their holders to own the underlying stock. For purposes of determining the section 382 limitation, the IRS concluded that it is appropriate to take into account the actual value of warrants.

Based on the rationale of this ruling, it appears that the value of "in-the-money" options should be included in the value of the old loss corporation in computing the section 382 limitation. Although out-of-the-money options generally *do not* have a value equal to the underlying shares, they may nonetheless have a speculative or other value and presumably such value should be included in the annual limitation.

In addition, value may be controversial where changes in control are occasioned by reorganizations, particularly where the purchase price consists in whole or in part of stock of a nontraded corporation.

(iii) Long-Term Tax-Exempt Rate

The long-term tax-exempt rate is the highest of the federal long-term rates determined under I.R.C. section 1274(d), as adjusted to reflect differences between rates on long-term taxable and tax-exempt obligations in effect for the month in which the ownership change date occurs or the two prior months.[47] The rates are

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[45] *Id*.

[46] See infra § 6.4(e)(vii).

[47] I.R.C. § 382(f).

published monthly in Revenue Rulings. The rate for ownership changes during January 2004 was 4.58 percent.[48]

The long-term tax-exempt rate is the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years. This rate has been subject to some criticism, because an investor would not assume the risks associated with a business venture merely to receive a long-term tax-exempt bond rate.

> **EXAMPLE 6.1**
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> Assume that all of the stock of Target Corporation is acquired for $1 million on December 31, 2001, when the long-term tax-exempt rate is 10 percent. Target has 2002 taxable income, before net operating loss carryovers, of $60,000. The "section 382 limitation" for 2002 is $100,000 (10 percent of $1 million). The $40,000 of unused limitation in 2002 will increase the section 382 limitation for 2003 to $140,000.

(c) Allocation of Taxable Income for Mid-Year Ownership Changes

In general, when an ownership change occurs mid-year, the loss corporation may use NOL carryovers to shelter taxable income allocable to the prechange period without limitation.[49] Taxable income (loss) may be allocated to pre- and post-change periods on a daily pro rata basis. Alternatively, a loss corporation may elect to "close the books" on the ownership change date and allocate income (loss) between the pre- and postchange periods based on actual financial information.

For ownership changes occurring before June 22, 1994, a closing-of-the-books election required that the loss corporation obtain a private letter ruling from the IRS.[50] On June 22, 1994, however, closing-of-the-books regulations were finalized and, as a result, the election can be made without the consent of the IRS.[51] These regulations provide that loss corporations may allocate regular and/or alternative minimum tax (AMT) income (loss) between pre- and postchange periods based on

[48] Rev. Rul. 2004-2, 2004-2 I.R.B. 1.

[49] I.R.C. § 382(b)(3)(A).

[50] Notice 87-79, 1987-2 C.B. 387; Treas. Reg. §1.382-6(a), (b)(1). After the issuance of Notice 87-79, but prior to the issuance of proposed and final regulations, a number of private letter rulings allowed a closing-of-the-books and an allocation of income to the pre-change portion of the year. *See, e.g.*, Private Letter Ruling 9229020 (Apr. 20, 1992); Private Letter Ruling 8901055 (Oct. 14, 1988). To receive such a ruling, the taxpayer represented the following:

- The taxpayer would file the information statement required by Temp. Treas. Reg. section 1.382-2T(a)(2)(ii), stating that the election is being made to allocate losses before and after the change date, based on an actual closing-of-the-books of the taxpayer and each member of its affiliated group.
- The taxpayer and members of its affiliated group did not accelerate income to the pre-change period or defer loss to the post-change period for purposes of avoiding the application of the I.R.C. section 382(b) limitation.
- All corporations within the taxpayer's affiliated group would be treated consistently for purposes of allocating income and loss under I.R.C. section 382(b)(3). All companies within the taxpayer's affiliated group will close its books as of the change date and will elect out of ratable allocation.

[51] Treas. Reg. §1.382-6; T.D. 8546, 59 Fed. Reg. 32078 (June 22, 1994).

either (1) closing the books, or (2) daily pro rata allocation. The irrevocable closing-of-the-books election is made on the information statement required by Temp. Treas. Reg. section 1.382-2T(a)(2)(ii) for the change year.[52]

The regulations provide rules for allocating taxable income (loss) and net capital gain (loss) to pre- and postchange periods. The taxable income (loss) is determined without regard to capital gains or losses, the section 382 limitation, recognized built-in gains (losses), or "abusive gains," as discussed below. The net capital gain (loss) is likewise determined without regard to these items. The net capital gain (excluding any I.R.C. section 1212 short-term capital losses) allocated to each period is offset by recognized built-in losses of a capital nature and capital loss carryovers subject to the section 382 limitation. Any taxable loss allocated to each period is then reduced by any capital gain allocable to the same period and then by any remaining capital gain from the other period.

The preambles to the proposed and final closing-of-the-books regulations provide that taxable income or loss allocated to either the prechange or postchange period cannot exceed the total net operating loss or taxable income for the change year. For example, a corporation with pre-change income of $2,000 and a post-change loss of $1,000 would allocate $1,000 of income to the pre-change period and $0 to the post-change period if it makes a closing-of-the-books election. A few special points are noted below:

- Recognized Built-in Gains (Losses). Recognized built-in gains (losses) (see § 6.4(h) below) are allocated separately from operating income (loss).[53] Thus, to the extent a loss corporation has a net unrealized built-in gain on the ownership change date, built-in gain recognized during the post-change portion of the year is allocated entirely to the post-change period, regardless of whether operating income (loss) is allocated based on daily proration or closing the books.
- Abusive Gain. Income or gain recognized on the disposition of assets transferred to a loss corporation to ameliorate the annual limitation must be allocated entirely to the post-change period.[54]
- Extraordinary Items. The regulations do not contain any special allocation provisions for extraordinary items. The preamble to the regulations, however, indicates that the IRS may give further consideration to the "desirability" of rules regarding the allocation of extraordinary items to pre- and post-change periods.

[52] Treas. Reg. §1.382-6(b)(2). The election is made no later than the due date of the loss corporation's income tax return for the change year, unless the IRS grants an extension. *See, e.g.*, Private Letter Ruling 200125056 (Mar. 14, 2001) (granting an extension to file closing-of-the-books election under Treas. Reg. section 1.382-6(b)); Private Letter Ruling 9817012 (Jan. 15, 1998) (same).

[53] Treas. Reg. §1.382-6(c)(1)(ii)(A).

[54] Treas. Reg. §1.382-6(c)(1)(ii)(B).

EXAMPLE 6.2 DAILY PRORATION

Consider the following facts relating to Loss Corporation:

Fair market value of all stock	$10,000,000
Net operating loss carryover (1/1/02)	4,000,000
Income for 2002	1,000,000
Long-term tax-exempt rate	6%

All the stock of Loss Corporation is sold on October 1, 2002. The section 382 limitation is computed as follows:

- Value ($10,000,000) X long-term tax-exempt rate (6%) = $600,000 income per year that can absorb the net operating loss.
- No limitation applies to that portion of the year preceding (and including) the change date.[55] Thus, 275/366 X $1,000,000 = $750,000 of income that can offset the loss.
- The portion of the taxable year remaining after the change date is subject to the section 382 limitation, which is also prorated. Thus, 91/366 X $600,000 (annual limitation) = $150,000 of postchange 2002 income can also absorb the net operating loss carryover. This analysis assumes that no closing-of-the-books election is made.

EXAMPLE 6.3 CLOSING-OF-THE-BOOKS METHOD

A calendar-year loss corporation, XYZ, with NOL carryovers of $25 million and a value of $60 million has an ownership change on March 31, 1995. Income from the first quarter is $15 million, while income for the remainder of the year is $1 million. The resulting applicable limitation for 1995 would be approximately $3.074 million [$60 million × 6.83% AFR (then-applicable ling-term tax-exempt rate) × 3/4 post-change period]. Based on a daily proration, total income of $16 million would be allocated proportionately throughout the year. Thus, XYZ may fully shelter the $4 million of income, which is allocated to the pre-change period, with its pre-change NOL carryovers. XYZ may, however, shelter only $3,074,000 of the $12 million of income allocated to the post-change period. If instead, XYZ elected to use the closing-of-the-books method, XYZ could fully shelter pre- and post-change income, because the $1 million of income allocated to the post-change period is less than both the limitation for 1995 and the available NOL carryovers.

(d) Ownership Change

Recall that the section 382 loss limitation rules do not come into play unless there has been an ownership change. Until an ownership change takes place, a loss corporation can use all of its losses without a "section 382 limitation," and none of the numerous restrictions and limitations of I.R.C. section 382 applies. An ownership change occurs if, on a testing date, the percentage of stock of a loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points relative to the lowest percentage of stock of the

[55] I.R.C. § 382(b)(3)(A).

old loss corporation owned by those 5-percent shareholders at any time during the testing period (generally, three years).[56]

The determination of whether an ownership change has occurred on a date on which there has been an owner shift (a "testing date") is made by comparing the increase in value in percentage stock ownership (if any) for each 5-percent shareholder as of the close of the testing date, with the lowest percentage of stock owned by each such 5-percent shareholder during the three-year testing period. The three-year period generally does not begin before the first day of the first tax year from which there is a loss or credit carryover to the first postchange year.[57] Stock owned by persons who own less than 5 percent of a loss corporation is generally treated as stock owned by one or more 5-percent shareholder(s).[58]

The ownership change test bears a distinct similarity to old I.R.C. section 382(a) and the definition of "purchase." Under the prior law, a determination was made as to whether the ten largest shareholders of the loss corporation increased their ownership interest of the loss corporation by 50 percentage points or more over the previous two taxable years. Prior law, however, had two completely different tests, depending on whether there was a taxable purchase (ten largest shareholders and 50 percent change of ownership) or a tax-free reorganization (20 percent continuity of shareholder interest). Current I.R.C. section 382(g) has one test: an ownership change by 5-percent shareholders totaling more than 50 percentage points. Although the statutory framework categorizes an ownership change as either (1) an owner shift involving 5-percent shareholders, or (2) an equity structure shift (i.e., a reorganization), there is usually no distinction between the two; they are really the same test.

In determining whether an ownership change has occurred, the general rule is that changes in the holding of all "stock" are taken into account, except that preferred stock described in I.R.C. section 1504(a)(4) is generally disregarded.[59] I.R.C. section 1504(a)(4) stock is preferred stock that is nonvoting and nonconvertible, and that does not participate in corporate growth and has a reasonable redemption or liquidation premium. Although such preferred stock is not counted as stock for purposes of determining whether there is an ownership change, it is generally included as stock for purposes of determining the value of the loss corporation.[60] There are several additional exceptions to the definition of stock, each of which functions as an anti-abuse rule. More specifically, if cer-

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[56] I.R.C. § 382(g), (k). A loss corporation is entitled to rely on the presence or absence of SEC filings (e.g., Schedules 13D, 13G) to determine the existence of 5-percent shareholders, unless the loss corporation has contrary actual knowledge regarding the ownership of the stock. Treas. Reg. § 1.382-2T(k). *See also* Private Letter Rulings 9533024 (May 19, 1995) and 9610012 (Dec. 5, 1995).

[57] I.R.C. § 382(i)(3). Special rules apply for corporations with built-in losses. *See also* Treas. Reg. § 1.382-2T(d).

[58] I.R.C. § 382(g)(4)(A).

[59] I.R.C. § 382(k)(6); Treas. Reg. § 1.382-2(a)(3)(i). Percentages of stock for this purpose are determined by value and all shares of a given class of stock are presumed to have an equal value.

[60] I.R.C. § 382(e)(1).

tain conditions are met, one exception provides that an ownership interest that is otherwise treated as stock may not be treated as stock for purposes of determining whether an ownership change has occurred. Another exception provides that an ownership interest that otherwise would not be treated as stock and is not an option (as described in § 6.4(e)(iv)) may be treated as stock in determining whether an ownership change has occurred and in determining the value of a loss corporation to compute the section 382 limitation.[61]

(i) *Examples of Ownership Changes Involving Sales among Shareholders*

The determination of whether an ownership change has occurred is demonstrated in Examples 6.4 through 6.7.

Example 6.4

Drew Corporation Shareholders

Shareholder	1/1/00	12/31/03	Increase
A	15%	10%	—
B	10	15	5
C	0	20	20
D	30	10	—
E	20	3	—
F	10	12	2
G	10	30	20
H	3	0	—
I	2	0	—
	100%	100%	47

In this simplified situation, where all ownership changes took place on one day (December 31, 2003), there was no statutory ownership change of the loss corporation. Shareholders B, C, F, and G increased their stock ownership by a total of 47 percentage points, but there was no change in stock ownership aggregating more than 50 percentage points. If on December 31, 2003, however, shareholder A also purchased all of D's stock interest, there would be an ownership change for Drew Corporation. A would own 20 percent of Drew Corporation and would have increased his interest from the lowest point in the three-year period by 10 percentage points. This, coupled with the other shareholders' 47-point increase, would result in an increase of more than 50 percentage points.

[61] Treas. Reg. § 1.382-2T(f)(18). *See also* Field Service Advice 199910009 (Dec. 2, 1998) (regarding whether debt should be treated as stock, and whether stock should be treated as not being stock in determining ownership change under I.R.C. section 382). *See also* § 6.4(e)(v), (vi), (vii) for rules that deem options to be exercised (and thus treated as stock) for purposes of I.R.C. section 382.

EXAMPLE 6.5

Bryce Corporation Shareholders

	1/1/00	12/31/03	1/1/04
A	0%	25%	4%
B	0	25	4
C	0	25	4
D	0	25	4
Public	100	0	84
	100%	100%	100%

In 2000, Bryce was a public company. No shareholder owned 5 percent of the stock. At the end of 2003, four individuals purchased all the stock of Bryce. There was a 100 percentage point change and thus an ownership change on December 31, 2003. (A public-to-private or leveraged buy-out of a public company will be an ownership change; a private company that goes public will also undergo an ownership change.) If, pursuant to a public offering of stock on January 1, 2004, individuals A, B, C, and D each decrease their holdings from 25 percent to 4 percent, there will be an 84 percentage point change. On January 1, 2004, the public is treated as one "5-percent shareholder" that owns 84 percent (all less-than-5-percent shareholders are grouped together, but A, B, C, and D are treated separately because they were previously 5-percent shareholders). Because the public owned no stock as of December 31, 2003, there was an 84 percentage point increase by the public.

An existing public company whose stock is widely traded and whose shareholders completely change during a three-year period does not experience an ownership change. This is because all less-than-5-percent shareholders are treated as one or more 5-percent shareholders, such that a complete change in small public shareholders will, under the statute, represent a zero percentage point change during the three-year period.

Note, however, that a group of shareholders acting pursuant to a plan may be treated as a separate entity, even though none of the shareholders individually acquires 5 percent of the loss corporation's stock.[62] For example, assume Public owns 100 percent of Loss. If Q buys newly issued stock constituting 46 percent of the outstanding stock of Loss from Loss, and five friends acting in concert each buy 1 percent of the Loss stock from Public, an ownership change will take place. This rule applies for testing dates after November 19, 1990. Because SEC regulations require disclosure of owners acting in concert, taxpayers may generally rely on the absence of such disclosures to conclude that no such separate entity exists.[63]

Once a shareholder is a 5-percent shareholder at any time within the testing period, he or she is a separate shareholder even though the interest held may be less than 5 percent at other relevant times within the testing period.[64] Assume a

[62] Treas. Reg. § 1.382-3(a)(1)(iii) (examples).

[63] *See, e.g.,* Private Letter Rulings 9725039 (Mar. 26, 1997), 9533024 (May 19, 1995), and 9407025 (Nov. 22, 1993).

[64] I.R.C. § 382(k)(7).

loss corporation (L) has 25 separate 4 percent shareholders. Five of those shareholders sell 1 percent each of their stock to the remaining 20 shareholders (each of whom ends up owning 5 percent of L). There is a presumption that each of the 20 shareholders (who own 5 percent of L) owned no stock in L beforehand, causing a 100 percentage point shift in the ownership of L and an ownership change.[65] This presumption is overcome by actual knowledge that the 20 shareholders actually owned 4 percent each in L beforehand, resulting in only a 20 percentage point owner shift.[66]

EXAMPLE 6.6

MVL Corporation Shareholders

	December 31			
	1999	2000	2001	2002
A	0%	5%	10%	20%
B	0	10	50	20
C	70	55	30	20
D	5	30	10	20
E	25	0	0	20
	100%	100%	100%	100%

At the end of 2000, there is only a 40 percentage point increase (A = 5, B = 10, and D = 25). At the end of 2001, there is a 65 percentage point increase compared to the lowest point in the period (A = 10, B = 50, D = 5) and, thus, an ownership change. At the end of 2002, it would be improper to conclude that there was another ownership change. Although there is a 55 percentage point increase in A, B, and D's interest between January 1, 2000, and December 31, 2002 (a three-year period), I.R.C. section 382(i)(2) provides that once there is an ownership change (on December 31, 2001), the testing period for determining whether a second ownership change has occurred "shall not begin before the first day following the change date for such earlier ownership change," which, in this example, is January 1, 2002. Thus, from January 1, 2002, to December 31, 2002, there is only a 40 percentage point change (A =10, D = 10, E = 20).

Because an increase in stock ownership is measured by reference to the lowest percentage of stock owned by a 5-percent shareholder at any time during the testing period, if a 5-percent shareholder disposes of loss corporation stock and subsequently reacquires all or a portion of such stock during the testing period, the increase resulting from the subsequent acquisition is taken into account in determining whether an ownership change has occurred (even if the percentage ownership between the first and last day of the testing period is the same or has decreased).

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[65] Temp. Treas. Reg. § 1.382-2T(g)(5).
[66] Temp. Treas. Reg. § 1.382-2T(k)(2).

EXAMPLE 6.7

On June 1, 2002, M sold 35 percent of Booth Corporation stock to N and on August 1, 2002, M purchased O's 20 percent stock interest.

	Percentages		
Individuals before:	2/1/01	6/1/02	8/1/02
M	40	5	25
N	40	75	75
O	20	20	0
	100	100	100

An ownership change takes place on August 1, 2002. Even though M's interest has decreased from 40 percent to 25 percent on the testing date (August 1, 2002), M's interest is 20 percentage points greater than its lowest percentage of stock owned during the three-year testing period. This, coupled with N's increase of 35 percentage points during the three-year period, results in a 55 percentage point increase and an ownership change.

This is the rule even though there would be no ownership change if the two sales were reversed in time. Thus, if M purchased O's 20 percent interest on June 1, 2002, and M sold 35 percent to N on August 1, 2002, there would be no ownership change. On the testing date (August 1, 2002), M has not increased his interest in T Corporation from any point within the three-year period. M's increase of 20 percentage points from February 1, 2001, to June 1, 2002, is immaterial to the August 1, 2002, testing date. Therefore, only N's increase of 35 percentage points occurred on the August 1, 2002, testing date.

Even if M first sold a 35 percent stock interest to N and then purchased 20 percent from O (as in the original facts), there would still not be an ownership change if the sale and purchase took place on the same day.[67]

(ii) Other Transactions Giving Rise to Ownership Changes

Transactions other than sales among shareholders can also result in ownership changes. These include redemptions (including I.R.C. section 303 redemptions to pay death taxes), public offerings, split-offs, I.R.C. section 351 incorporations, recapitalizations, reorganizations, and stock becoming worthless. This is a significant broadening of the transactions covered, compared with the prior-law definition of a "purchase." Only changes in stock ownership resulting from gift, death, divorce, or separation,[68] pro rata dividends and pro rata spin-offs, by the very nature of the distribution, do not result in an ownership change.

It may be possible to structure the stock of an entity to prevent an ownership change from occurring. For example, the IRS has ruled that if a company's stock certificates are labeled with a legend restricting the transfer of the certificate if

[67] Temp. Treas. Reg. § 1.382-2T(a)(2)(i).

[68] I.R.C. § 382(l)(3)(B). *See also* I.R.C. § 382(l)(3)(C), which permits taxpayers to disregard changes in proportionate ownership attributable solely to fluctuations in the relative value of different classes of stock. *See also* Private Letter Ruling 200411012 (Dec. 5, 2003) (interpreting I.R.C. section 382(l)(3)(C)).

such transfer would cause an ownership change, such an arrangement is sufficient to preclude an ownership change. The mechanics of the restriction prohibited any transfer with the potential to cause an ownership change, including a return of the shares represented by the certificates to non-5-percent shareholders, a return of the purchase price to the purported acquirer, and a return of all vestiges of ownership (e.g., dividends) to the selling shareholder.[69]

(iii) Examples of Ownership Changes Resulting from Other Transactions

EXAMPLE 6.8

	Public Offering Missy Corporation Shareholders			
	1/1/00	6/15/00	6/15/01	12/15/01
A	1,000 (100%)	700 (70%)	700 (53.8%)	500 (45.5%)
B	0	300 (30%)	300 (23.1%)	300 (27.2%)
C	0	0	100 (7.7%)	100 (9.1%)
D	0	0	100 (7.7%)	100 (9.1%)
E	0	0	100 (7.7%)	100 (9.1%)
	1,000 (100%)	1,000 (100%)	1,300 (100%)	1,100 (100%)

On June 15, 2000, A sells 300 shares to B. There is no ownership change, because B's interest has increased by only 30 percentage points. On June 15, 2001, C, D, and E each buy 100 newly issued Missy shares from Missy. The latter issuance of shares, coupled with the prior sale, still yields only a 47 percentage point increase in stock ownership. When A has 200 shares redeemed on December 15, 2001, there is a 55 percentage point increase and an ownership change.

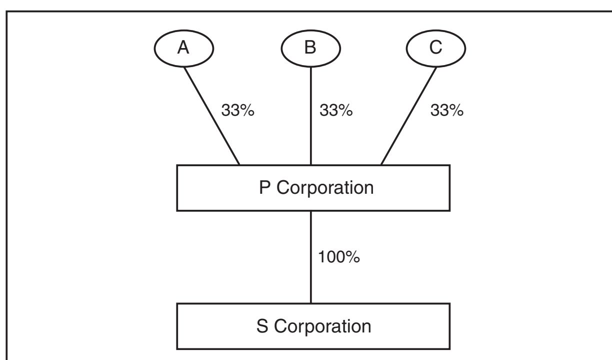
EXAMPLE 6.9 SPLIT-OFF

A pro rata dividend or spin-off of loss corporation S to individuals A, B, and C results in a zero percentage point change. (See Exhibit 6.1.) A, B, and C own one-third of S both before and after the transaction. If loss corporation S is distributed to C in complete redemption (under I.R.C. section 302(b)(3)) of C's interest in P, or if P splits off S to C under I.R.C. section 355 in complete surrender of C's interest in P, there is an increase of 67 percentage points and an ownership change. C's interest increased from a 33 percent indirect interest in S to a 100 percent direct interest in S. If, in the same redemption or split-off above, P is the loss corporation, there is no ownership change. Both A and B would have increased their interest in P from 33 percent to 50 percent for only a combined 34 percentage point interest.

[69] *See* Private Letter Ruling 8949040 (Sept. 11, 1989).

EXHIBIT 6.1

Corporate Spin-Off Resulting in Zero Percentage Point Change



EXAMPLE 6.10 I.R.C. SECTION 351 TRANSFER

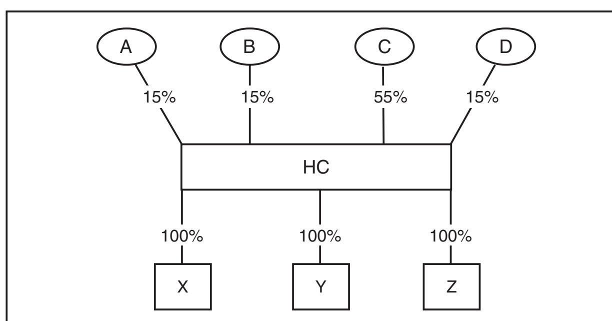
Even the mere formation of a holding company can be an ownership change.

Assume individual A owns 100 percent of the stock of X Corporation, individual B owns 100 percent of the stock of Y Corporation, and individual C owns 100 percent of the stock of Z Corporation. All corporations have net operating loss carryovers. A, B, and C each transfer 100 percent of the stock of their respective corporations to a new holding company (HC), and investor D transfers cash to the HC. After the transaction, the corporate structure is as shown in Exhibit 6.2.

With respect to both X and Y, there has been an ownership change. C and D own 55 percent and 15 percent, respectively, of corporations X and Y after the creation of the holding company. The introduction of new 5-percent shareholders creates an 85 percentage point increase in the shares of X and Y. There is no ownership change, however, as to Z Corporation, because A, B, and D each own 15 percent afterward (zero beforehand) for a total increase of 45 percentage points.

EXHIBIT 6.2

Corporate Structure after Transfer to a Holding Company



EXAMPLE 6.11 RECAPITALIZATION

Nonvoting, nonconvertible, nonparticipating, preferred stock with a reasonable redemption and liquidation premium is disregarded as stock in determining whether there has been a more than 50 percentage point increase.[70] Thus, a stock-for-stock as well as a debt-for-stock recapitalization can result in an ownership change.

Assume Loss Corporation is owned by individual A (75 percent) and individual B (25 percent). If A exchanges his common stock for an issuance of nonvoting preferred stock (under I.R.C. section 1504(a)(4)), B will be deemed to own all of Loss Corporation after the recapitalization. A's preferred stock interest is disregarded. Similarly, if C, D, and E (creditors of Loss Corporation) surrender their claims for more than 50 percent of Loss Corporation stock, there will be an ownership change.

EXAMPLE 6.12 WORTHLESSNESS

Under prior law, if stock held by a taxpayer became worthless during the tax year, a loss deduction was allowed. Even if a worthless stock deduction had been claimed by a parent corporation with respect to stock of a nonconsolidated subsidiary, the net operating loss carryovers of the subsidiary survived and could be used to offset future income of the subsidiary.[71]

Current I.R.C. section 382(g)(4)(D) provides that a more-than-50-percent shareholder who treats his stock as having become worthless is treated as a new shareholder on the first day of the succeeding taxable year. Thus, an ownership change results and the net operating loss carryovers are subject to the section 382 limitation.[72]

(iv) Equity Structure Shift

An equity structure shift is a reorganization other than a mere change in form ("F" reorganization) or a divisive reorganization (generally, a spin-off under I.R.C. section 355).[73] An equity structure shift that results in an increase of more than 50 percentage points in the stock ownership of a loss corporation is an ownership change.[74] The identity of the loss corporation as the transferor or acquiring corporation is irrelevant. Thus, if X Corporation (a loss corporation) merges into Y Corporation (also a loss corporation) in exchange for 60 percent of the stock of Y, there is an equity structure shift. Because the pre-existing shareholders of Y own only 40 percent of Y after the merger, there is no ownership change for X, but there is an ownership change for Y. The result would be the same if Y merged into X and the Y shareholders received 40 percent of X. As previously discussed, only changes by shareholders owning 5 percent or more are counted. Although the

[70] I.R.C. § 382(k)(6)(A).

[71] *Textron, Inc. v. United States,* 561 F.2d 1023 (1st Cir. 1977).

[72] The shareholder's stock will be treated as having become worthless if the shareholder takes a worthless stock deduction. In the consolidated group setting, Treas. Reg. section 1.1502-80(c) provides that for consolidated return years beginning on or after January 1, 1995, stock of a member is treated as worthless if it is "disposed of" within the meaning of Treas. Reg. § 1.1502-19(b)(2)(ii).

[73] I.R.C. § 382(g)(3)(A) (either a "D"/355 or a "G"/355).

[74] I.R.C. § 382(g)(1).

less-than-5-percent shareholders are aggregated and treated as one shareholder, the less-than-5-percent shareholders of the transferor and acquiring corporation are segregated and treated as separate 5-percent shareholders. For this reason, the relative fair market values of the transferor and acquiring corporation may determine whether an equity structure shift is an ownership change and to which corporation (i.e., the acquiring corporation or the target corporation assuming both the acquiring and target corporations are loss corporations).[75]

(v) Purchases and Reorganizations Combined

A purchase and an equity structure shift can be combined within the testing period to cause an ownership change.

EXAMPLE 6.13

Loss Corporation (L) has been owned by individual B for 10 years. Individual C purchased 20 percent of L from B on August 1, 2000. On February 15, 2002, L merged into P Corporation and in the merger the L shareholders received 55 percent of P.

The equity structure shift on February 15, 2002, caused an ownership change. Even though the "former" shareholders of L (as of February 15, 2002) maintained a 55 percent interest in P, B did not retain more than 50 percent of P. C is not considered a former shareholder of L, because C acquired her interest within the three-year testing period. After the merger, the composition of the P shareholders is as follows:

	Percentage in P
B	44%
C	11
Historical P shareholders	45
	100%

Because C, along with the historical P shareholders, will own more than 50 percentage points (56) following the merger, there is an ownership change with respect to L.

The result would not be different if the merger had preceded the purchase (i.e., if the merger took place on August 1, 2000, and C's purchase occurred on February 15, 2002). The August 1, 2000 equity structure shift (merger) would not have resulted in an ownership change, because the historical P shareholders would only own 45 percent of P, the surviving corporation. C's purchase of 11 percent of P from B would be an ownership change, however, because, within the testing period, the historical P shareholders (45 percent) and B (20 percent) increased their percentage interest in L's losses by more than 50 percentage points.

(e) Public Shareholders and the Segregation Rules

(i) Introduction

Recall that the less-than-5-percent shareholders of a corporation are aggregated and treated as one individual shareholder. Thus, 25 unrelated but equal share-

[75] *See* Private Letter Ruling 9028065 (Apr. 13, 1990) (determining which entity undergoes an ownership change in the merger of two mutual banking organizations is made by comparing the deposit base of each entity).

holders of X Corporation are treated as one shareholder (Public X). Similarly, the stock of IBM Corporation would be owned by one shareholder (Public IBM). Trades among the public shareholders are disregarded. If each of the 25 shareholders of X (above) on one day (but not pursuant to a plan) sells all of his or her X stock to 25 new but equal shareholders, there is no ownership change even though the shareholder composition of X has changed completely. If 10 of the X shareholders sell all their stock (40 percent) to A and each of the other 15 equal shareholders sells 4 percent of the stock to 15 other new shareholders (B through P, respectively), there is only a 40 percent owner shift and thus no ownership change.

Although trading among members of a public group is disregarded for purposes of determining an owner shift, when a loss corporation makes a public offering or otherwise issues new stock (including issues pursuant to equity structure shifts, redemptions, exchanges of stock for property (I.R.C. section 1032 transactions), and the issuance of some options), the less-than-5-percent shareholders who receive the new stock are segregated from the existing public group and treated as a new public group.[76]

For example, if a corporation issues additional stock to a new individual 5-percent shareholder, and at the same time issues warrants to the public to acquire its stock, the public is treated as a separate 5-percent shareholder, and the shares issuable to the public can be aggregated with the increase in the individual 5-percent shareholder's ownership for purposes of testing for an ownership change.[77]

Although conceptually sound, this segregation principle is difficult to implement because it requires a corporation to determine the extent to which newly issued stock is acquired by existing, as opposed to new, shareholders. A complex set of temporary regulations addressed this issue.

On November 4, 1992, the IRS issued two sets of proposed regulations under I.R.C. section 382. The first set proposed alterations in the presumption concerning the creation of new public groups as a result of new issuances (the "segregation presumption"), and also introduced a new exception to the segregation rules for small issuances (the "small issuance exception").[78] The second set addressed the treatment of options in determining whether a loss corporation has an ownership change.[79] The first of these two sets of proposed regulations (the segregation rules) was finalized on October 4, 1993, with only minor changes that will be discussed below.[80] These final regulations apply to issuances of stock in tax years beginning on or after November 4, 1992, and they permit taxpayers to elect to apply the rules retroactively.

The second of these two sets of proposed regulations (the option rules) was finalized on March 17, 1994.[81] These final regulations are more forgiving than their temporary regulation predecessors, and unlike the proposed regulations, they do include some safe harbors, but these new rules were not given

[76] See Treas. Reg. § 1.382-2T(j)(2).
[77] *See* Rev. Rul. 90-15, 1990-1 C.B. 93.
[78] 57 Fed. Reg. 52738 (Nov. 5, 1992).
[79] 57 Fed. Reg. 52743 (Nov. 5, 1992).
[80] T.D. 8490, 58 Fed. Reg. 51571 (Oct. 4, 1993).
[81] T.D. 8531, 59 Fed. Reg. 12832 (Mar. 18, 1994).

retroactive effect. The effective date of the option regulations is for any testing date on or after November 5, 1992 (the date the proposed regulations were issued).[82] The focus of these final regulations is on the testing date and not the date the option is issued. Thus, a ten-year option to acquire 30 percent of the stock of a loss corporation, issued on March 1, 1989, is subject to the final regulations (and not the temporary regulations) if there was no ownership change between March 1, 1989, and November 4, 1992 (i.e., the 30-percent option plus other owner shifts did not add up to a greater-than-50-percent ownership change within any three-year period prior to November 5, 1992). Conversely, options that contributed to an ownership change under the temporary regulations will not be considered outstanding for any subsequent testing date.

Taxpayers may elect to apply the old temporary regulations for testing dates that would normally be covered by the final regulations for any testing date between November 5, 1992, and May 17, 1994 (60 days after the regulations are finalized). Often, it is better to trigger an ownership change earlier rather than later. This would be the case when a corporation continues to generate losses (later losses would not be restricted by an early ownership change) or when the "section 382 limitation" would be greater in the earlier period (e.g., the value of the corporation or the long-term tax-exempt rate is higher in the earlier period). In such cases, this election may be appropriate. In addition, corporations in bankruptcy may elect to apply the old rules for any petition filed on or before May 17, 1994.

Although it has been over ten years since the current segregation rules and option rules were proposed (1992), taxpayers could still be faced with situations in which the old temporary regulations apply. Therefore, the discussion that follows will first briefly review the old temporary regulations and will then discuss the proposed and final regulations. The old, proposed, and then current regulations addressing segregation will be discussed first, and the old, proposed, and final option rules will be discussed second.

(ii) Segregation: Old Temporary Regulations

The touchstone of the old temporary regulations was the presumption that newly issued shares were acquired solely by new (as opposed to existing) shareholders.

There was a presumption of no overlap (i.e., the shareholders who acquire stock of the loss corporation in the public offering were presumed not to include any member who owned stock in Y beforehand).[83] The "overlap" presumption could be overcome by actual knowledge of cross-ownership.

An entire lexicon developed under the old temporary regulations, including first-tier entity, higher-tier entity, highest-tier entity, 5-percent owner, 5-percent shareholder, public shareholder, public owner, and public group. The complexity of these old regulations was wholly disproportionate to their applicability, and the great bulk of transactions were analyzed without resort to them.

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[82] There is an exception to this general effective date for the control test. The control test generally will not apply to options issued on or before March 17, 1994, or within 60 days after that date, pursuant to a plan in existence before that date.

[83] Old Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B).

(iii) Segregation: Proposed Regulations

In recognition of the practical problems of determining cross-ownership, the proposed regulations created a new presumption on the subject of cross-ownership ("segregation presumption"). In addition, to reduce the administrative burden created by keeping track of small separate public groups, the proposed regulations excluded from consideration certain small issuances of stock ("small issuance exception").

(A) Segregation Presumption

If a loss corporation issues stock for cash, the no-cross-ownership presumption is replaced with a presumption that a prescribed percentage of the newly issued stock was acquired by existing direct public groups.[84] That prescribed percentage is equal to 50 percent of the total percentage owned by the existing public groups prior to the new issue. Thus, if a corporation with 100 percent of its stock owned by one public group issues 20 new shares to the public, 10 shares (20 shares × 50 percent × 100 percent) would be deemed issued to the existing public group and the remaining 10 shares would be deemed issued to a new public group. As a result, there would be an owner shift of 8 percent (10/120), rather than the 17 percent (20/120) owner shift that would result under the old temporary regulations.

If some of the stock outstanding before the new issue is owned by more-than-5-percent shareholders rather than by public groups, then the percentage of stock owned by public groups will be less than 100 percent and the resulting prescribed percentage will change.

Example 6.14

Assume loss corporation (L) has 100 shares outstanding and has two shareholders: A, an individual who owns 30 percent (30 shares), and B, a public group that owns 70 percent (70 shares). If L issues 40 new shares to the public (no one shareholder acquiring 5 percent or more), the prescribed percentage will be 35 percent (50 percent × 70 percent); 14 shares will be deemed issued to the existing public group (35 percent × 40 shares) and the remaining 26 shares will be deemed issued to a new public group.

If any of the newly issued stock is acquired by a more-than-5-percent shareholder (either one in existence before the new issue or one created by the new issue, but other than a public group), a limitation applies. Under the limitation, the loss corporation must compute the difference between the value of the total shares newly issued and the value of those shares acquired by a more-than-5-percent shareholder (other than a public group). If that amount is lower than the

[84] Former Prop. Treas. Reg. § 1.382-3(j)(3). A direct public group is a public group that owns shares in a loss corporation directly (or indirectly through an entity that generally owns less than 5 percent of the loss corporation), rather than through an entity. Subsequent examples assume public groups are direct public groups. *See* Treas. Reg. §§ 1.382-2T(j)(2)(ii), -2T(j)(1)(iv)(C).

amount computed by the prescribed percentage, then the lower amount is used to determine an allocation of newly issued shares to existing public groups.

EXAMPLE 6.15

Assume L has 100 shares outstanding and all of them are owned by a single public group. If L issues 40 new shares and Z acquires 30 of them, then the public group will be deemed to have acquired the lower of (1) the prescribed percentage amount of 20 (50 percent × 40) or (2) the limitation amount of 10 (40 shares - 30 shares acquired by more-than-5-percent shareholders (other than a public group)). Thus, the public group will be deemed to have acquired all 10 of the shares not acquired by Z and no new public groups will be created.

EXAMPLE 6.16

Assume the ownership of L's shares is the same as in Example 6.14 (30 by an individual and 70 by a public group) and that the new issue of 40 shares is acquired by Z (20) and by the public (20). The existing public group will now be deemed to have acquired the lower of (1) the prescribed percentage amount of 14 (50 percent × 70 percent × 40 shares) or (2) the limitation amount of 20 (40 - 20). Thus, 14 shares will be deemed acquired by the existing public group, 20 shares will be acquired by Z, and the remaining 6 shares will be deemed acquired by a new public group.

The foregoing examples can be summarized by the following rule:

> The number of shares deemed issued to the existing public groups is the lesser of:
>
> > 50 percent × Percent of stock owned by all public groups before the new issue × Number of shares issued in the new issue
>
> *or*
>
> > Total shares issued in the new issue less shares issued to more-than-5-percent shareholders (other than a public group).

(B) Small Issuance Exception

If a loss corporation issues stock to the public (no 5-percent shareholders) other than in an acquisitive reorganization, and the issuance is "small" within the meaning of the proposed regulations, there will be no segregation and the issuance will not result in the creation of a separate public group.[85] "Small" is defined as 10 percent, and, at the election of the corporation, can be (1) 10 percent of the value of the loss corporation's stock outstanding at the beginning of the year (excluding "vanilla preferred" stock under I.R.C. section 1504(a)(4) or

[85] Former Prop. Treas. Reg. § 1.382-3(j)(2). The small issuance exception does not apply to issuances pursuant to an "equity structure shift." I.R.C. section 382(g)(3)(A) defines an equity structure shift by excluding "D-355," "G-355," and "F" reorganizations, and Former Prop. Treas. Reg. section 1.382-3(j)(6) excludes "E" reorganizations from the definition. Thus, only acquisitive reorganizations ("A," "B," "C," and "D/G-354s") are excluded from the small issuance exception.

(2) 10 percent of the shares of the class of stock being issued that is outstanding at the beginning of the year. Notice that the issuance of a new class of stock can never qualify under (2): if it is a new class, none of it will be outstanding prior to the issue, and 10 percent of zero is zero.

The election is made yearly. If the 10 percent limitation is not met with respect to an issuance, that entire issuance will fail to meet the small issuance exception. If there are multiple public issues during the year, each of which meets the small issuance limitation, those issues combined together must nevertheless meet the 10 percent limitation. If they do not, however, only the excess of the combined yearly issues above the 10 percent limitation will be ineligible for the small issuance exception. If the excess amount was issued for cash, a portion of it may escape allocation to a new public group under the new segregation presumption. If the excess amount was not issued for cash, it will all be deemed issued to a new public group.

Actual knowledge that a new issuance was acquired by an existing public group is a "one-way street" for the benefit of the taxpayer. If the segregation presumption (or the small issuance exception) results in a greater amount of stock being received by the existing public group than would be received by using actual knowledge, then the segregation presumption (or small issuances exception) controls. If actual knowledge results in a greater amount of stock being received by the existing public group than would be received by using the segregation presumption (or the small issuance exception), then actual knowledge controls.[86]

Example 6.17

Loss Corporation, a calendar-year taxpayer, has 1,000 shares of stock outstanding owned by B (20 percent) and the public (80 percent). In June, Loss Corporation issues 40 shares in a public offering for cash. In October, Loss Corporation issues another 105 shares in exchange for debt. The June offering satisfies the small issuance limitation of 100 (10 percent × 1,000) and all 40 shares are deemed issued to the existing public group. None of the October issuance meets the small issuance limitation, however. In addition, none of the October issue can qualify for the new segregation presumption because the shares were not issued for cash. As a result, the entire 105 shares are deemed issued to a new public group.

Example 6.18

Assume the same facts as in Example 6.17, except that Loss Corporation had actual knowledge that all 105 of the shares issued in October were acquired by the existing public. In that case, all 145 shares would be deemed issued to the existing public. No new public group would be created.

[86] Former Prop. Treas. Reg. § 1.382-3(j)(5)(ii).

EXAMPLE 6.19

Assume the same facts as in Example 6.17, except that 95 shares were issued in October instead of 105 shares. The June and the October issues would each meet the small issuance exception, but 35 shares (the excess of the combined small issuances (40 + 95) over the 10 percent limitation (100) would fail to qualify for the exception. Assuming the 35 nonqualifying shares are deemed to come from the 95 shares issued for debt, and not from the 40 shares issued for cash, then no relief would be available under the new segregation presumption, and all 35 of the excess shares would be deemed issued to a new public group.

The limitation under the segregation presumption, restricting the amount of the new issue that can be deemed acquired by the existing public groups, also applies to the small issuance exception.[87] In the small issuance context, the limitation restricts the amount of a new issue that can be deemed acquired by the existing public groups to the lesser of (1) the amount qualifying for the small issuance exception or (2) an amount equal to the difference between the total shares issued and those acquired by the more-than-5-percent shareholders (other than a public group).

EXAMPLE 6.20

Using the same beginning ownership as in Example 6.17 (B = 20 percent; public = 80 percent), assume a single June offering of 40 shares in exchange for debt, of which 15 shares are acquired by B. Under the small issuance exception alone, all 40 of the shares would qualify for the exception and would be deemed issued to the existing public group (40 shares is less than 10 percent × 1,000 shares). Applying the limitation, however, the amount deemed issued to the existing public group is equal to the lesser of 40 or 25 (shares issued less shares acquired by more-than-5-percent shareholders (other than a public group)). As a result, only 25 shares will be deemed issued to the existing public group.

(iv) Segregation: Final Regulations

With the exception of two minor changes, the final segregation rules are almost identical to the proposed segregation regulations issued November 4, 1992, which are described above.

The two minor changes to the proposed segregation rules are:

1. The 50 percent presumption is only applicable to cash issuances. Although two or more issuances that occur at the same time are treated as a single issuance, the issuance of some stock for cash and some stock for other property (e.g., debt) will be treated as issued in part for cash and in part for other property. In other words, the shares issued for cash will be eligible for the 50 percent presumption and the shares issued for debt will not.[88] Furthermore, the 50 percent presumption will not apply to stock issued for cash if, as a condition of acquiring that stock for cash, the

[87] *See* Former Prop. Treas. Reg. § 1.382-3(j)(4).
[88] Treas. Reg. § 1.382-3(j)(13), Ex. 3.

acquirer is required to purchase other stock for consideration other than cash.[89]

2. The proposed rules with regard to the 50 percent presumption attempted to provide the same treatment for issuances of options as for issuances of stock. Thus, the proposed rules provided that the loss corporation was required to take into account any transfers and actual exercise of options. The finalized rules make that intention clearer. For example, assume Corporation L with 100 shares outstanding, all owned by a single public group, distributes rights to acquire L stock (one right for each share held). The issuance of options to an existing public group owning all of the stock of L will not cause an owner shift. Moreover, the actual transfer of those options between less than 5-percent shareholders will also be disregarded.[90] An actual exercise of those options will not be disregarded, however.[91] Thus, for purposes of the 50 percent presumption, and assuming all the rights are exercised, 50 shares will be deemed issued to the existing public group and 50 shares will be deemed issued to a new public group. The "actual knowledge rule" of Treas. Reg. section 1.382-2T(k)(2) will apply only to the extent that the loss corporation specifically knows that the individuals exercising the rights were members of the existing public group.

(v) Options: Temporary Regulations

Solely for the purpose of determining whether there is an ownership change on any testing date, the old temporary regulations provided that the stock of the loss corporation that was subject to an option would be treated as acquired on any such date (pursuant to an exercise of the option by its owner on that date) if such deemed exercise would result in an ownership change.[92] The option rule was applied separately to each class of options and each 5-percent shareholder. Thus, certain options would be counted as exercised and others may be disregarded, depending on whether the deemed exercise would cause an ownership change.

Options were broadly defined to include warrants, rights, convertible debt, convertible stock, a put, a stock interest subject to a risk of forfeiture in favor of another party, an option to acquire an option to acquire stock, and a contract to acquire or sell stock. Thus, an executory contract to sell stock, a bilateral agreement to sell stock, or a contract to sell stock subject to third-party approval (FCC, Justice Department, IRS, shareholders) was an option. Such an option created an owner shift at the time of the preliminary agreement, notwithstanding the contingency involved.

In case of a stock acquisition or similar agreement, the date of the ownership change was generally the time when the transaction must be carried out, as a

[89] Treas. Reg. § 1.382-3(j)(13), Ex. 4.
[90] Treas. Reg. § 1.382-3(j)(10).
[91] *Id.*
[92] Old Temp. Treas. Reg. § 1.382-2T(h)(4).

legal or practical matter. Thus, an agreement to sell stock became an option at the time the boards of directors of both the target and acquiring companies have approved the acquisition,[93] and a public stock offering became an option subject to the I.R.C. section 382 attribution rules when it was publicly announced.[94]

"Convertible pure preferred stock" (i.e., stock described in I.R.C. 1504(a)(4) but for the conversion feature and the ability to share in growth as a result of such stock) was treated like convertible debt (i.e., an option). The effect was to make the convertible stock an "evergreen" option rather than to classify that stock as a currently acquired outstanding stock interest (limiting the testing period to three years). Such stock (i.e., the option), however, would continue to be treated as stock for purposes of computing the value of the loss corporation. Convertible pure preferred stock with voting rights would be treated as stock and not as an option. These rules were applicable to stock issued after July 20, 1988.[95] The IRS has reserved the right, in the Treasury Regulations under I.R.C. section 382, to issue exceptions to the option attribution rules merely by publication of notice in the Internal Revenue Bulletin.[96] For example, the IRS held that the transfer of a thrift institution to the Management Consignment Program of the Federal Savings and Loan Insurance Corporation (FSLIC) did not create an option under I.R.C. section 382.[97]

The actual exercise of an option was disregarded if the existence of the option caused an ownership change. If the exercise took place within 120 days after the date on which the option was deemed exercised (because it created an ownership change), then the taxpayer could elect to treat the actual exercise date as the date of the ownership change.[98]

In the case of an I.R.C. section 338 election, if the signing of the agreement to sell stock of a loss corporation and the closing were within 120 days, then the option attribution rules of old Treas. Reg. section 1.382-2T(h)(4)(vi)(B) would permit the I.R.C. section 382 change date to be the actual closing date (which would be the same date as the section 338 acquisition date and the section 338 one-day return). Thus, none of the deemed sale gain under I.R.C. section 338 would be in a postchange year to which the section 382 limitation would apply. Note that I.R.C. section 338(h)(1)(C), as modified by the Technical Corrections Act of 1987, achieved the same favorable result by increasing the section 382 limitation.

Certain options were disregarded under the old temporary rules:

- Options exercisable only upon death, complete disability, or mental incompetency of the owner.

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[93] *See* Private Letter Ruling 8847067 (Aug. 29, 1988); Private Letter Ruling 8903043 (Oct. 14, 1988). *But see* Private Letter Ruling 9211028 (Dec. 13, 1991) (option created on date of tender offer).

[94] *See* Private Letter Ruling 8917007 (Jan. 6, 1989).

[95] Notice 88-67, 1988-1 C.B. 555.

[96] Old Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(Z).

[97] *See* I.R.S. Notice 88-7, 1988-1 C.B. 476.

[98] Old Temp. Treas. Reg. § 1.382-2T(h)(4)(B).

- Options, exercisable upon retirement, between noncorporate owners, both of whom participate in management. Options between a noncorporate owner (who participates in management) and the redeeming corporation are also covered. In both cases, however, the option must have been issued when the corporation was not a loss corporation.
- Options exercisable upon default of a loan from a domestic bank, insurance company, or certain qualified trusts.
- Options between non-5-percent shareholders.
- The right of the loss corporation to redeem stock of less-than-5-percent shareholders.
- Any right to receive, or obligation to issue, stock of a corporation in payment of interest or dividends by the issuing corporation.
- Any option with respect to stock of the loss corporation, which stock is actively traded on an established securities market, if the option has been continuously owned by the same 5-percent shareholder for three years. The exception to option attribution expires at the earlier of when the option is transferred by or to a 5-percent shareholder, or when the fair market value of the stock that is subject to the option exceeds the exercise price.
- The right to receive stock at maturity, pursuant to the terms of a debt instrument, if the amount of the stock transferred at maturity is equal to a fixed dollar amount divided by the then value of each share.
- Options that, on the testing date, pertain to stock of a corporation with de minimis loss. De minimis losses are prechange losses that are less than twice the section 382 limitation.
- Options outstanding immediately before and immediately after an ownership change.

If an option caused an ownership change that limited loss carryovers and it turned out that the option was in fact never exercised (due to lapse or forfeiture), the loss corporation could file a claim for refund as if there had been no ownership change.

The IRS ruled that a mere modification of the terms of an exchange offer did not cause a lapse or forfeiture of the original offer, because the holder of the option never relinquished any of its rights. A lapse or forfeiture did occur when an option expires, even though renewed several days later on the same terms.[99] Furthermore, a redemption of options that caused an ownership change did not constitute a lapse or forfeiture sufficient to undo the previous ownership change.[100]

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[99] *See* Private Letter Ruling 8917007 (Jan. 6, 1989).
[100] *See* Private Letter Ruling 8930034 (May 1, 1989).

(vi) Options: Proposed Regulations

Under the proposed regulations addressing options, an option (including stock warrants, stock rights, incentive stock options, stock subject to risk of forfeiture, puts, convertible debt, contracts to acquire stock) would only be considered the equivalent of the underlying stock (i.e., deemed exercised) so as to contribute to an ownership change under I.R.C. section 382, if it was "*issued or transferred for an abusive principal purpose*."[101] Absent such a purpose, the option was disregarded in determining whether an ownership change took place, until it was actually exercised. This was a complete reversal from the temporary regulations, which disregarded all contingencies as to time and event and treated the mere existence of the option as ownership of the underlying stock, if such treatment resulted in an ownership change. The result was that an ownership change could occur in a time period before exercise of the option.

Under the proposed regulations, an "abusive principal purpose" is defined as a principal purpose of manipulating the timing of an owner shift to ameliorate or avoid the impact of an ownership change of a loss corporation by (1) providing the holder of the option with a substantial portion of the attributes of ownership of the underlying stock or (2) facilitating the creation of income to absorb the corporation's losses prior to the exercise of the option. The proposed regulations provided that the determination of principal purpose was to be based on facts and circumstances. Six factors that provided evidence of such a purpose were:

1. The option is "deep-in-the-money" on the date the option is issued or transferred. If the exercise price is at least 90 percent of fair market value, this factor is not met.
2. The option holder can participate in the management of the loss corporation (other than through a bona fide employment arrangement).
3. The option includes rights that would ordinarily be afforded to the owner of the underlying stock (e.g., voting, dividend, or liquidation rights).
4. The option holder has a call option with respect to the stock of the loss corporation, and the loss corporation has a matching put option to sell the stock to the option holder.
5. In connection with the issuance or transfer of the option, the loss corporation receives a capital contribution (either in exchange for stock or otherwise).
6. In connection with the issuance or transfer of the option, the loss corporation enters into a transaction with a view to accelerating income into the period prior to the exercise of the option.

Although these were merely factors in evaluating abusive purpose, if any of these factors was present and the loss corporation did not treat the option as exercised, disclosure on the loss corporation's return was required.

[101] Former Prop. Treas. Reg. § 1.382-4(d)(2)(i) (emphasis added).

Factors (5) and (6) above reflect the concern of the Treasury Department, as expressed in the preamble to the proposed regulations, that an investor might contribute money to a loss corporation in exchange for an option, wait until that money is used by the loss corporation to engage in a profitable venture so as to absorb existing losses, and then convert the option. If the investor initially purchased stock instead of an option, an ownership change would take place on the date of that purchase, limiting the use of the losses.

The concern embodied in factors (5) and (6) also formed the basis of the government's arguments in *Maxwell Hardware Co. v. Commissioner*,[102] in which the taxpayers, who were engaged in the real estate business, invested in a loss-corporation hardware business in exchange for nonvoting preferred stock. The invested proceeds were used to finance a profitable real estate venture with a resulting offset of the losses of the hardware business. The hardware corporation was later liquidated and the investors received the real estate assets. The government presented evidence that the liquidation had been contemplated from the outset, and that one of the investors was made a member of the board and appointed vice president of the corporation and manager of the new real estate department. The Ninth Circuit rejected the government's argument that the transaction constituted impermissible trafficking in loss carryovers on the narrow ground that the investment had not exceeded the 50 percent threshold of the provisions of I.R.C. section 382 under the 1954 code.

Under the standards of the proposed regulations, it is possible that the contemplation of a future liquidation and the participation in management would cause an investment such as that in *Maxwell Hardware* to be treated either as "stock" or as an option issued for "an abusive principal purpose." If the investment is treated as an option, the mere issuance of that option (as opposed to its later exercise) would trigger an ownership change.

This outcome is justified when an option is issued to a small number of new investors, but it makes little sense when convertible debentures are issued to the public to raise money for working capital, to retire debt, or to make an acquisition. Yet, the influx of new money into the loss corporation might be deemed a "contribution to capital" and an abusive principal purpose, which would mandate disclosure even in apparent nonabusive situations.

The proposed regulations provided that an option issued or transferred for an abusive principal purpose is treated as exercised, for purposes of determining whether an ownership change occurred, on the issuance date, the transfer date, and any subsequent testing date. Once such an option was treated as exercised and contributed to an ownership change, it was thereafter treated as exercised and could not contribute to an ownership change on any subsequent testing date. Moreover, any later actual conversion into stock was disregarded. This rule was consistent with the temporary regulations. The proposed regulations, however, provided an exception if the option was subsequently transferred for an abusive principal purpose. Under such circumstances, the proposed regulations provided that the option could again be counted toward an ownership change.

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[102] 343 F.2d 713 (9th Cir. 1965).

The proposed regulations provided that any stock described in section 1504(a)(4) that was convertible into stock other than section 1504(a)(4) stock issued after November 5, 1992, would be treated as stock for purposes of I.R.C. section 382. There was an exception for convertible stock with a conversion feature that permitted or required the tender of consideration other than the stock being converted. Such stock would be considered both stock and an option.[103]

(vii) Options: Final Regulations

On March 17, 1994, the IRS published in the *Federal Register* final regulations under I.R.C. section 382 addressing the conditions under which an option would be deemed exercised for purposes of determining whether an I.R.C. section 382 ownership change has occurred. The final regulations are more forgiving than their temporary regulation predecessors, and, unlike the proposed regulations, they do include some safe harbors. Unfortunately, the new rules were not given retroactive effect.

The final regulations delete the abusive factors of the proposed regulations and, with them, the disclosure requirement. Now, options are generally not treated as exercised unless they run afoul of an ownership test or a control test or an income test (all described below). The final regulations replace the abusive factors with "a series of factors that exemplify circumstances that may be probative under the ownership, control, and income tests."[104] Although this amorphous, ad hoc, and facts-and-circumstances approach will undoubtedly generate controversy on audit, it is far superior to either the temporary regulations, which had clear, definitive, but draconian rules, or the proposed regulations, with their abusive factors and disclosure requirements.

The inherently factual nature of each inquiry (and with it, a "principal purpose" determination) will undoubtedly preclude private letter rulings in this area. Thus, some uncertainty will always exist. Nevertheless, compared with the temporary regulations, taxpayers will certainly benefit from a subjective inquiry into whether the issuance of an option is tantamount to the issuance of stock. The final regulations follow the temporary and the proposed regulations in providing that options will not be deemed stock if stock classification helps the taxpayer avoid an ownership change.[105]

Unlike the old temporary regulations, the final regulations do not have a "lapse or forfeiture" rule under which options that contributed to an ownership change but were in actuality not exercised (i.e., they lapsed or were forfeited) could be expunged retroactively by the filing of an amended return. Although this rule made sense when practically all options were deemed the equivalent of stock (under the old temporary regulations), it is superfluous in a regime (under the final regulations) in which only specific and defined options are treated as the equivalent of stock.

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[103] As in the old temporary regulations, preferred stock that meets *all* the requirements of I.R.C. section 1504(a)(4) will be considered neither stock nor an option.

[104] T.D. 8531, 59 Fed. Reg. 12832 (Mar. 18, 1994) (Preamble, Part C).

[105] *See* Field Service Advice 199910009 (Dec. 2, 1999) for an application of the option rules under the temporary and final option regulations of I.R.C. section 382.

Under the final regulations, options are treated as exercised if the following two conditions are met.

Step 1. **Condition one.** A principal purpose[106] of the issuance, transfer, or structuring of the option is to avoid (or ameliorate) the impact of an ownership change of the loss corporation (hereafter, a "prohibited principal purpose"). Factors to consider in making this determination are: (a) the business purpose for the issuance, transfer, or structuring of the option, (b) the likelihood of exercise (taking into account contingencies), and (c) the consequences of treating the option as exercised. With respect to the last of these, if treating an option as exercised either causes by itself or contributes to an ownership change (at that time), the likelihood that the option will be treated as having a prohibited principal purpose will be enhanced.

Step 2. **Condition two.** Any one of the following tests is satisfied: (a) the ownership test, (b) the control test, or (c) the income test.

(A) Ownership Test

The ownership test is satisfied if the issuance, transfer, or structuring of the option provides the holder of the option (prior to its actual exercise or transfer) with a substantial portion of the attributes of ownership of the underlying stock.[107] Factors to consider are: (1) the relationship, at the time of the issuance or transfer of the option, between the exercise price and the value of the underlying stock (e.g., "deep-in-the-money" options are suspect); (2) whether the option provides the holder with the right to participate in management or with rights ordinarily afforded to owners of stock (e.g., future loss or appreciation);[108] (3) the existence of reciprocal options (i.e., a call held by the purchaser and a put held by the seller); and (4) whether a fixed exercise price option permits its holder to share in future appreciation. Treas. Reg. section 1.382-4(d)(9)(iv) provides, however, that paragraph (d) does not affect the determination of whether an instrument is an option or stock under general principles of tax law (such as substance over form).[109]

(B) Control Test

The control test is satisfied if the holder of the option has, in the aggregate (taking into account existing stock, stock held by related parties, and stock that could be acquired by exercising the option or options held by related parties), more than 50 percent of the loss corporation's stock.[110] It is unclear whether

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[106] A principal purpose may exist even when it is outweighed by nontax reasons.

[107] Treas. Reg. § 1.382-4(d)(3).

[108] The preamble to T.D. 8531 states: "The ability of the holder of an option with a fixed exercise price to share in future appreciation of the underlying stock is also a relevant factor, but is not sufficient, by itself, for the option to be treated as exercised." T.D. 8531, 59 Fed. Reg. 12832 (Mar. 18, 1994) (Preamble, Part C).

[109] *See* Rev., Rul. 82-150, 1982-2 C.B. 110.

[110] Treas. Reg. § 1.382-4(d)(4). The final regulations treat convertible stock as stock and provide special rules regarding the treatment of certain convertible stock as an option. Treas. Reg. §§ 1.382-2(a)(3)(ii); 1.382-4(d)(9)(ii).

merely satisfying the 50 percent test, coupled with a "prohibited principal purpose," is sufficient. The regulations are contradictory on this point.[111]

EXAMPLE 6.21

A, the founder of Loss Corporation, currently owns all of its stock. On January 1, 1995, A grants B an option to acquire 60 percent of Loss at any time within the next four years at $8,000. B also has the right to approve major corporate initiatives and veto individuals selected for senior officer positions. During the intervening four-year period, profit projections indicate that Loss's net operating loss will be used up. The facts suggest that the option might be treated as exercised on January 1, 1995. First, there is some evidence that a prohibited principal purpose exists: the profit projections give Loss Corporation a reason to want to delay the ownership change date. Second, the option would, if exercised, give B more than 50 percent of Loss Corporation's stock. Third, the grant of managerial rights to B (although perhaps not necessary to the conclusion) will add to the perception that control has passed to B.

(C) Income Test

The income test is satisfied if the issuance, transfer, or structuring of the option facilitated the creation of net income (accelerating income or deferring deductions) prior to the exercise or transfer of the option.[112] Factors to consider are: (1) whether in connection with the issuance or transfer of the option, the loss corporation engages in extraordinary income acceleration transactions, and (2) whether large capital contributions or loans are made to the loss corporation by the option holder, the proceeds of which are not used to continue basic operations of the business.

EXAMPLE 6.22

On January 1, 1995, Loss Corporation issues a debenture to B, convertible into 25 percent of the stock of Loss after two years. Loss uses the proceeds of the debenture to enter in a lease transaction that accelerates income currently and permits it to use existing net operating losses. The facts suggest that the convertible debenture might be treated as an exercised option on January 1, 1995. First, there is some evidence that a prohibited principal purpose exists: Loss would like to delay an ownership change if the delay will permit it to use its net operating losses. Second, the proceeds of the debenture have been used to enter into a lease that will accelerate income and permit the use of the net operating losses.

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[111] *Compare* T.D. 8531, 59 Fed. Reg. 12832 (Mar. 18, 1994) (Preamble, Part A, penultimate paragraph), "the control test will apply to a contingent option to acquire more than 50 percent of the stock of a loss corporation even though the option holder has no other relationship to the corporation . . . [providing a prohibited principal purpose exists]," *with* Treas. Reg. section 1.382-4(d)(6)(iii), "in applying the control test [consider] the economic interests in the loss corporation of the option holder or related persons and the influence of those persons over the management of the loss corporation. . . ."

[112] Treas. Reg. § 1.382-4(d)(5).

(D) Safe Harbors

The temporary regulations included a number of safe harbor situations in which options were not deemed exercised. Many of these were narrowly drawn. The proposed regulations dropped these few safe harbors. The final regulations now reinstate and broaden them.[113] They include:

1. Contracts to acquire stock, subject to reasonable closing conditions and provided the closing actually takes place within one year;[114]
2. An escrow, pledge, or other security agreement that is part of a typical lending transaction;
3. Reasonable compensatory options that are nontransferable and do not have a readily ascertainable fair market value (as defined in Treas. Reg. § 1.83-7(b)) on the date the option is issued;
4. Options exercisable upon death, disability, or retirement;
5. A right of first refusal;
6. Any option designated in the Internal Revenue Bulletin;
7. Situations in which neither the transferor nor the transferee of the option is a 5-percent shareholder.

I.R.C. section 382(l)(3)(B) contains protective relationships (death, gift, divorce, separation) in which the transfer of stock does not contribute to an owner shift. The final regulations accordingly provide that options given in the context of these relationships do not contribute to an owner shift.

(E) Subsequent Treatment of Options Treated as Exercised

The final regulations provide that an option that satisfies conditions one and two above is treated as exercised, for purposes of determining whether an ownership change occurs, on the issuance date, the transfer date, and on any subsequent testing date until there is an ownership change. Once an option is treated as exercised, it will continue to be treated as exercised until it contributes to an ownership change.[115] Thereafter, it will not be treated as exercised and it will not (unless retransferred) contribute to a further ownership change on any subsequent testing date. Moreover, any later actual conversion into stock will be disregarded.

A loss corporation is permitted to treat any option actually exercised within three years of the date of its issuance or transfer as retroactively exercised on the date of such issuance or transfer (the "alternative look-back rule election"). This election could be used to advantage by a taxpayer to avoid a second ownership

[113] Treas. Reg. § 1.382-4(d)(7).

[114] Although contracts to acquire stock within one year are a safe harbor exclusion from the ownership test and the control test, they are not excluded from the income test. Apparently, the payment to the loss corporation of money or property (pursuant to entering into a contract to purchase stock) can be used to accelerate income, and the final regulations police this potential "abuse."

[115] Treas. Reg. § 1.382-4(d)(10).

change, where the issuance of an earlier option that was deemed exercised caused an initial ownership change.

EXAMPLE 6.23

Individual A owns 100 percent (49 shares) of Loss Corporation. Loss Corporation issues an option to B to acquire 51 newly issued shares of Loss Corporation stock. Although B does not exercise the option, it is deemed exercised and an ownership change takes place. Neither the option (the 51 shares "outstanding" as a result of the deemed exercise) nor a later actual exercise will count for determining a subsequent ownership change. Subsequently, A sells all of her 49 shares to C. Because the shares represented by the B option are disregarded, A's sale will be treated as a disposition of 100 percent (49/49) of Loss Corporation, and another ownership change will take place.

Under the rule in Treas. Reg. section 1.382-4(d)(10)(ii) (the alternative look-back rule), if B actually exercises his option within three years, Loss Corporation may disregard the general rule that "once an ownership change occurs, a subsequent exercise is disregarded" and, instead, treat the option to B as actually exercised on the date B received the option. Thus, Loss Corporation would have 100 shares of stock outstanding for purposes of determining whether A's sale to C causes another ownership change. If the shares represented by B's option are deemed outstanding, the sale to C would not cause another ownership change, because it would result in an ownership shift of only 49 percent (49/100). Consistent with this rule, any transfer by B of the option (within the three-year period) would be treated as a transfer of the shares subject to the option and not the option itself. An amended return may have to be filed.

(f) Reductions in the Section 382 Limitation

Notwithstanding the mathematical precision of the "section 382 limitation" under I.R.C. section 382(b) (i.e., the value of the old loss corporation multiplied by the long-term tax-exempt rate), a number of subjective concepts override the formula and either reduce or eliminate the net operating loss carryover. These are: the requirement for continuity of business enterprise,[116] the limitation on nonbusiness assets,[117] the restrictions on certain contributions to capital, [118] and redemptions and other corporate contractions.[119]

(i) Continuity of Business Enterprise

Following an ownership change, a corporation's net operating losses are subject to complete disallowance unless the loss corporation's business enterprise is continued at all times during the two-year period following the ownership change.

[116] I.R.C. § 382(c).
[117] I.R.C. § 382(l)(4).
[118] I.R.C. § 382(l)(1).
[119] I.R.C. § 382(e)(2).

The Committee Reports to the 1986 Act indicate that the continuity of business enterprise requirement is the same requirement that must be satisfied to qualify a transaction as a tax-free reorganization under I.R.C. section 368 and Treas. Reg. section 1.368-1(d).[120]

Under these continuity of business enterprise requirements, a loss corporation (or a successor) must either continue the old corporation's historical business or use a significant portion of the old loss corporation's assets in a business. Thus, the requirement may be satisfied even though the old loss corporation discontinues more than a minor portion of its historical business. Changes in the location of a loss corporation's business product, plant, equipment, or employees (in contrast to the prior law) will not cause the transaction to fail to satisfy the continuity of business enterprise test.

At a minimum, a corporation with three separate trades or businesses of equal size will be able to terminate two of them without violating continuity of business enterprise. Moreover, after the merger of loss corporation (L) into profit corporation (P), a termination of all active businesses of L and the use of the L assets in a business of P will also satisfy continuity of business enterprise.

(ii) Nonbusiness Assets

The value of the loss corporation may be reduced (for purposes of computing the section 382 limitation) if the loss corporation holds substantial nonbusiness assets after an ownership change.

The purpose of this restriction is unclear. It appears to add nothing not already covered by the continuity of business enterprise requirement. It may also violate one of the stated principles of I.R.C. section 382 (tax neutrality) and it will engender controversy by requiring a determination of the amount of nonbusiness assets. Apparently, the drafters were concerned about the appearance of "trafficking" in loss corporations when a small marginal business with substantial carryovers and substantial nonbusiness assets would advertise itself for sale based on its loss carryovers.

Substantial nonbusiness assets are defined as assets whose value is one-third or more of the value of the total assets of the corporation. Thus, there is a "cliff effect": only when the one-third threshold is met will the value of the loss corporation be reduced by the fair market value of the nonbusiness assets over the share of the liabilities attributable to those assets. Liabilities are apportioned to business and nonbusiness assets based on the relative fair market value of the respective assets. The corporation is not permitted to demonstrate that certain liabilities relate solely to nonbusiness assets. Each loss corporation asset is deemed to carry an equal share of liabilities.

Nonbusiness assets are assets held for investment. Significant controversy will arise over cash or marketable securities that could be deemed to be working capital. Assets held as an integral part of the conduct of a trade or business (e.g., funding reserves of a bank or insurance company) are not considered nonbusiness

[120] H.R. Rep. No. 841, 99th Cong., 2d Sess., at II-189 (1986).

assets. There is a "look-through" rule for subsidiaries. A parent will be deemed to own a ratable share of its subsidiaries' assets if the parent owns at least 50 percent of the vote and 50 percent of the value of the subsidiary.[121]

EXAMPLE 6.24 HANKO CORPORATION

Balance Sheet at Value	
Business assets	$ 6,000,000
Nonbusiness assets	4,000,000
Total assets	$10,000,000
Total liabilities	(8,000,000)
Net fair market value	$ 2,000,000

If individual M purchased Hanko Corporation for $2 million, the value of the corporation for purposes of the section 382 limitation would be reduced as follows:

Nonbusiness assets	$4,000,000
Nonbusiness assets share of indebtedness ($4,000,000 × $10,000,000 $8,000,000)	$3,200,000
Value reduction for section 382 limitation	$ 800,000
Value of Hanko for section 382 limitation purposes	$1,200,000

If the nonbusiness assets were $3 million and the business assets were $7 million, the value of Hanko for the section 382 limitation would be the full $2 million, not $1,200,000. This is because the nonbusiness assets represent only 30 percent of the total assets.

(iii) Contributions to Capital

Any capital contributions (including transfers under I.R.C. section 351) to a loss corporation, whose principal purpose is to increase the section 382 limitation or to avoid any limitation, are not given effect. This is known as the "anti-stuffing" rule. Without this rule, cash or other nonbusiness property could be transferred to a loss corporation prior to the sale of the loss corporation's stock. The buyer could reimburse the seller for the cash (or, in effect, buy the other nonbusiness property) in return for a greater loss limitation than it would have had if it had merely bought the nonbusiness property and contributed it (along with cash) to the loss corporation.

There is a conclusive statutory presumption (except to the extent provided in future regulations)[122] that any capital contribution made within the two-year period ending on the change date will be deemed to be for the prohibited pur-

[121] I.R.C. § 382(l)(4)(E).

[122] To date, no such regulations have been issued. The I.R.S. has, however, issued a number of private letter rulings in which taxpayers have been allowed to rebut the presumption. *See, e.g.*, Private Letter Ruling 9835027 (May 29, 1998); Private Letter Ruling 9706014 (Nov. 13, 1996); Private Letter Ruling 9541019 (July 10, 1995). In light of these rulings and examples in the legislative history, some contributions to capital within two years of an ownership change should be respected.

pose of increasing the loss limitation.[123] Hence, such a contribution will automatically be disallowed. The Committee Reports provide for the following permissible contributions to capital even if undertaken within the two-year period (and encourage the drafters of the regulations to include them):[124]

- Capital contributions received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss) where an ownership change occurs within two years of incorporation;
- Capital contributions received before the first year from which there is a net operating loss or excess credit carryover (or in which a net unrealized built-in loss arose);
- Capital contributions made to continue basic operations of the corporation's business (e.g., to meet the monthly payroll or fund other operating expenses of the loss corporation);
- Distributions made to shareholders subsequent to capital contributions, as offsets to such contributions.

The fate of the following seemingly proper contributions within the two-year period is unclear: (1) non pro rata contributions to capital which by their very nature are not schemes but are motivated by sound business reasons; (2) the issuance of common stock to raise funds to retire preferred stock; and (3) the conversion of debt into equity.

(iv) Redemptions and Other Corporate Contractions

The value of the loss corporation is reduced by any redemption of stock undertaken as part of the ownership change.[125] Thus, if Profit Corporation purchases 100 percent of Loss from Loss's shareholders for $2,000, the value of Loss is $2,000. If Profit acquires 50 percent of Loss from Loss's shareholders for $1,000 and Loss redeems the other 50 percent for $1,000, the value of Loss is $1,000. If Profit (a new corporation established to effectuate the purchase) borrows $2,000 from a bank, purchases 100 percent of Loss from Loss's shareholders, and then Profit merges downstream into Loss (with the debt being assumed by Loss), the value of Loss is presumably zero. Moreover, even if there is no downstream merger but Profit's debt can only be discharged by Loss's cash flow, the value of Loss is still zero.[126]

A 1995 Tax Court case, *Berry Petroleum Co. v. Commissioner*,[127] provides a first impression interpretation of three of the I.R.C. section 382 provisions described

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[123] I.R.C. § 382(l)(1)(B).
[124] H.R. Rep. No. 841, 99th Cong., 2d Sess., at II-189 (1986).
[125] I.R.C. § 382(e)(2). A redemption for this purpose includes a deemed redemption of the sort described in Rev. Rul. 78-250, 1978-1 C.B. 83. *See also* Private Letter Ruling 200406027 (Oct. 10, 2003) (various transactions not treated as corporate contractions and value not reduced).
[126] Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350), Joint Comm. Print at 32 (June 15, 1987).
[127] 104 T.C. 584 (1995), *aff'd*, 98-1 U.S. Tax Cas. (CCH) ¶ 50,398 (9th Cir. 1998) (unpublished opinion).

in this section: I.R.C. section 382(c) (continuity of business enterprise), I.R.C. section 382(e)(2) (corporate contraction), and I.R.C. section 382(1)(4) (nonbusiness assets). The I.R.C. section 382 aspects of the case arose out of Berry Petroleum's acquisition (through a wholly owned subsidiary) of all the stock of a loss company (Teorco). The acquisition resulted in an ownership change, and thus placed at issue Berry's ability to use Teorco's pre-acquisition losses to offset Teorco's post-acquisition income.

Teorco's assets at the time of the acquisition consisted primarily of leasehold interests in four heavy-oil properties. Another suitor (Tenneco) had previously bid $7.5 million for one of these four leasehold interests (Placerita), but the offer had been rebuffed because the seller was concerned with possible environmental liabilities associated with the remaining Teorco assets. Berry's $6.5 million offer for all of the stock of Teorco was made under an agreement with Tenneco to sell Tenneco the Placerita leasehold following Berry's acquisition of the Teorco stock. The agreement provided that Tenneco would pay Berry up to $1.25 million more than the final adjusted sales price of Teorco. The sale of Placerita was consummated (for $7.75 million) after the ownership change, in accordance with the agreement.

Shortly before the ownership change, Teorco sold (to an unrelated party) a piece of property adjacent to another of the four leasehold properties (Jasmin) in exchange for a $1.5 million note receivable. Teorco advanced Berry $1 million seven months after the ownership change date, and another $2.6 million three months later. Berry executed unsecured promissory notes at a market rate of interest, paid interest monthly, but never paid any principal. Three months after the second advance, Teorco canceled the debts in a formal distribution to Berry.

The IRS first argued that Berry's pre-arranged sale of Placerita caused the transaction to fail the continuity of business requirement of I.R.C. section 382(c). The court easily rejected this argument. The court drew an analogy between the I.R.C. section 382 continuity requirement and the continuity requirement in the I.R.C. section 368 regulations (either continue the historical business or use a significant portion of the historical business assets in a business). The court also noted that the governing I.R.C. section 382 continuity requirement was more lenient than the old I.R.C. section 382 requirement (under the 1954 Code), which required the acquired corporation to "continue to conduct a trade or business substantially the same as its historical business." Although the court acknowledged that Berry had sold Placerita ("the most valuable property owned by Teorco"), the court determined that Berry's continued operation of the other Teorco assets satisfied the continuity requirement.

The IRS's second argument was based on I.R.C. section 382(e)(2) (redemption or other corporate contraction "in connection with" an ownership change). The IRS argued that Teorco's cancellation of the advances it had made to Berry constituted a "corporate contraction" within the meaning of I.R.C. section 382(e)(2), requiring a $3.6 million reduction ($1 million advance plus $2.6 million advance) in the $6.5 million value placed on Teorco by Berry. The Tax Court agreed with this IRS argument. Berry proffered two counterarguments, each of which was rejected by the court. Berry argued that the cancellation, albeit a dividend, was not a "corporate contraction" within the meaning of I.R.C. section

382(e)(2). The court determined that there could be a "corporate contraction" for I.R.C. section 382(e)(2) purposes, even if the contraction did not amount to a partial liquidation under prior law. Furthermore, applying the "special scrutiny," the court found appropriate in cases in which a controlling shareholder withdraws funds from its controlled corporation, the court determined that neither Berry nor Teorco ever intended the advances to be repaid. Finally, the court held that even if the advances had been genuine, Teorco's formal cancellation amounted to a "corporate contraction." Berry argued that even if the cancellation were a corporate contraction, it did not occur "in connection with" the ownership change. In response to this argument, the court acknowledged that the Ninth Circuit (to which Berry would be appealable) had construed "in connection with" for purposes of I.R.C. section 162(k) more narrowly than the Tax Court.[128] Nevertheless, the Tax Court determined that the Ninth Circuit's reading of the I.R.C. section 162(k) language did not extend to I.R.C. section 382. Thus, the Tax Court construed the language broadly (as it had in Fort Howard), concluding that the advances and their cancellation were connected to the ownership change because the ownership change occasioned Berry's need for funds. The court therefore concluded that the value of Teorco established by Berry had to be reduced by $3.6 million, the amount of the canceled advances. The general principle that emerges from this holding is that a dividend shortly after an ownership change may trigger a reduction in value under I.R.C. section 382(e)(2).

The IRS's third argument was based on I.R.C. section 382(l)(4) (substantial nonbusiness assets). The parties appear to have agreed that both the sale of Placerita and the sale of the Jasmin property converted business assets into nonbusiness assets. With respect to the sale of Placerita, however, the parties offered very different interpretations of I.R.C. section 382(l)(4). The IRS argued that although the sale of Placerita took place after the ownership change, Berry's binding agreement to sell it (entered into before the ownership change) essentially converted it into a pre-ownership change sale. Thus, according to the IRS, the appropriate reduction in the value of the loss corporation under I.R.C. section 382(l)(4) was the full sales price of Placerita ($7.75 million) plus the $1.5 million for the pre-ownership change sale of the Jasmin property.

Berry countered that I.R.C. section 382(l)(4) did not apply unless at least one-third of the value of the assets of the old (pre-ownership change) loss corporation were nonbusiness assets. According to Berry, because Placerita was not sold until after the ownership change, the old loss corporation did not have substantial nonbusiness assets. Furthermore, as the court acknowledged, the Jasmin receivable, by itself, constituted only one-eighth of the value of the old loss corporation.[129] Thus, according to Berry, the appropriate reduction in value of the loss corporation under section 382(1)(4) was zero.

The court recognized that the statute required a section 382(l)(4) reduction if the *new* loss corporation has substantial business assets, but that the statutes test for substantial nonbusiness assets refers only to the *old* loss corporation. Rather

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[128] Compare *United States v. Kroy (Europe) Ltd.*, 27 F.3d 367 (9th Cir. 1994), *with Fort Howard Corp. v. Commissioner*, 103 T.C. 345 (1994), *modified*, 107 T.C. 187 (1996).

[129] *See Berry*, 104 T.C. 584, 651 n. 50.

than explicitly resolving this statutory impediment, the court concluded that Berry had 70 percent nonbusiness assets and that this amount was undoubtedly substantial.

Having thus determined that Berry's valuation of Teorco was subject to reduction under I.R.C. section 382(l)(4), the court, in accordance with the statute, turned to the appropriate amount of that reduction. In computing the amount, the court looked to Teorco's nonbusiness assets immediately before the ownership change. The net result was that the court declined to reduce the value of the loss corporation by the $7.75 million in cash and notes received upon the sale of Placerita (because Placerita was a business asset in the hands of the old loss corporation), but reduced the value by the $1.5 million attributable to the Jasmin receivable.

Following these adjustments, the value of the loss corporation that the taxpayer asserted was $6.5 million was reduced by the court ($3.6 million for the corporate contraction and $1.5 million for substantial nonbusiness assets) to $1.4 million.

The I.R.C. section 382 issues discussed in *Berry* are addressed explicitly by the regulations for corporations subject to the special bankruptcy provisions in I.R.C. sections 382(l)(5) and 382(l)(6), discussed later in this chapter. In general, the continuity of business requirement does not apply for purposes of I.R.C. section 382(l)(5) but does apply for purposes of I.R.C. section 382(l)(6).[130] The corporate contraction adjustment applies to the stock value test of I.R.C. section 382(l)(6), but not to the asset value test of I.R.C. section 382(l)(6).[131] The nonbusiness asset limitation applies for purposes of both the stock value test and the asset value test of I.R.C. section 382(l)(6).[132]

(g) Special Rules

(i) Introduction

Corporations under the jurisdiction of a court in a title 11 or similar case may be subject to special provisions of I.R.C. section 382.[133] In general, although a bankrupt corporation undergoes an ownership change pursuant to I.R.C. section 382(g), section 382(l)(5) provides that the section 382(a) limitation will not apply if certain conditions are met.[134] Instead of the section 382(a) limitation, any net operating loss carryover (and excess credits) may be subject to certain limited reductions.

[130] *See* Treas. Reg. § 1.382-9(m).

[131] *See* Treas. Reg. §§ 1.382-9(k)(2); 1.382-9(l)(2).

[132] *See* Treas. Reg. §§ 1.382-9(k)(5); 1.382-9(l)(5). The stock value test and the asset value test are discussed § 6.4(g)(ii)(B).

[133] The transaction resulting in an ownership change must either be ordered by a court or occur pursuant to a plan approved by a court. Treas. Reg. § 1.382-9(a).

[134] Note that the bankrupt corporation still undergoes an ownership change. Therefore, if a "net unrealized built-in loss" exists as of the change date, an adjustment for computing adjusted current earnings will still be made under I.R.C. section 56(g)(4)(G) for determining alternative minimum taxable income.

Alternatively, bankrupt corporations meeting the conditions of I.R.C. section 382(l)(5) may elect out of that section and apply section 382(l)(6). Under section 382(l)(6), the section 382(a) limitation will apply; however, the net operating loss carryovers (including excess credits) will not be reduced and the value of the bankrupt corporation will be increased for certain items. The increase in value will increase the "section 382 limitation," thereby increasing the loss corporation's ability to use its net operating loss.

(ii) I.R.C. Section 382(l)(5)

(A) General Provisions

The special rules of I.R.C. section 382(l)(5) will apply only if an ownership change occurs within the meaning of I.R.C. section 382(g). To determine whether an ownership change has occurred, the normal rules of I.R.C. section 382 apply, as discussed in sections 6.3(d) and 6.3(e) above. Special rules apply for certain options, however.[135]

I.R.C. section 382(l)(5) provides that the "section 382 limitation" will not apply to a corporation if (1) immediately before an ownership change, the corporation was under the jurisdiction of a court in a federal bankruptcy proceeding or similar case, and (2) after an ownership change, the prechange shareholders and "qualified creditors" of the loss corporation own stock constituting 50 percent or more of the vote and value of the new loss corporation, as a result of being shareholders or "qualified creditors" immediately before such change (the "continuity requirement").[136] "Vanilla preferred" stock (I.R.C. section 1504(a)(4) stock) is not counted in determining this continuity requirement, but parent company stock will be counted, provided the parent company is also in bankruptcy.

For purposes of determining whether the continuity requirement has been met, options are deemed exercised if their exercise would cause the transaction to fail to satisfy the continuity requirement.[137] A qualified creditor can, however, treat an option actually exercised during the three-year period following the ownership change as stock outstanding for purposes of determining whether the plan qualifies under I.R.C. section 382(l)(5).[138] Thus, a plan that may fail to qualify for I.R.C. section 382(l)(5) treatment due to the deemed exercise of options, which would defeat the continuity requirement, could be revitalized so as to qualify for I.R.C. section 382(l)(5) treatment, by the actual exercise of options by qualifying creditors.

For example, suppose loss corporation L in a title 11 case approved by the bankruptcy court proposes to cancel its existing stock in exchange for new stock and options to be acquired as follows: 50 shares of stock and options to acquire an additional 25 shares to qualified creditors; options to acquire 60 shares to a new

[135] Treas. Reg. § 1.382-9(o).

[136] *See* Private Letter Ruling 9619051 (Feb. 8, 1996) (for purposes of determining whether I.R.C. section 382(l)(5) applies, stock transferred to a trust for the benefit of present and future claimants will be treated as transferred to and held by those claimants on the date the stock is transferred to the trust).

[137] Treas. Reg. § 1.382-9(e).

[138] Treas. Reg. § 1.382-9(e)(2)(ii).

investor. The options issued to the new investor, if they were deemed exercised, would cause the qualified creditors to own less than 50 percent (50 out of 110 shares, or 45 percent) of the voting power and value of the total stock after the ownership change. The options issued to the qualified creditors would not, if deemed exercised, cause the transaction to fail the continuity requirement; thus, they would not be deemed exercised. As a result, only the new investor's options would be deemed exercised and the continuity requirement would not be met.

If during the three-year period following the ownership change, however, the qualified creditors actually exercised 15 of their 25 options, those exercised options would be counted as shares outstanding for purposes of the continuity test, and the 50 percent requirement would be met (qualified creditors would own 65 of 125 shares outstanding, or 52 percent).

A "qualified creditor" is the beneficial owner of "qualified indebtedness" of the loss corporation immediately before the ownership change.[139] A qualified creditor owns stock of the loss corporation as a result of satisfaction of "qualified indebtedness" pursuant to the bankruptcy reorganization plan.[140]

"Qualified indebtedness" is (1) indebtedness owned by the same beneficial owner for the continuous 18-month period prior to the bankruptcy filing or (2) indebtedness that arose in the ordinary course of business of the loss corporation and has always been owned by the same beneficial owner.[141] Special rules apply if indebtedness is a large portion of a beneficial owner's assets.[142] For purposes of determining whether qualified indebtedness exists, regulations provide special rules for indebtedness not owned by a 5-percent shareholder or a 5-percent entity (the latter defined as an entity through which a 5-percent shareholder owns an indirect ownership interest in the loss corporation).[143] Special "actual knowledge" exceptions may also apply.

The IRS has ruled that retirees who are entitled to receive lifetime medical coverage under a corporation's unfunded welfare benefit plan are treated as unsecured creditors whose claims for benefits arose in the ordinary course of the corporation's business. Therefore, stock of the corporation transferred in satisfaction of a claim of a retiree is counted for purposes of determining whether the 50 percent test of I.R.C. section 382(l)(5)(A)(ii) is met.[144]

If I.R.C. section 382(l)(5) applies, two[145] special rules must be followed:

1. Net operating losses are reduced by interest paid or accrued on indebtedness converted to stock during any taxable year ending during the three-

[139] *See* Treas. Reg. § 1.382-9(d).
[140] Treas. Reg. § 1.382-9(d)(1).
[141] Treas. Reg. § 1.382-9(d)(2).
[142] Treas. Reg. § 1.382-9(d)(4).
[143] Treas. Reg. § 1.382-9(d)(3).
[144] *See* Private Letter Ruling 8902047 (Oct. 28, 1988).
[145] Prior to the Omnibus Reconciliation Act of 1993, which repealed the stock-for-debt exception of I.R.C. section 108(e)(10), prechange losses were reduced by 50 percent of any attribute reduction that would have been required under I.R.C. section 108, if the stock-for-debt exception of section 108(e)(10)(B) had not applied. Old I.R.C. § 382(l)(5)(C). For a discussion of the stock-for-debt exception, *see* § 2.4(c).

year period preceding the taxable year in which the ownership change occurs, and during the period of the tax year of the ownership change before the change date.[146]

2. After an ownership change that qualifies for the bankruptcy exception, a second ownership change during the following two-year period will result in a zero section 382 limitation with respect to the second ownership change.[147]

I.R.C. section 382(l)(5)(B) indicates that the net operating loss is reduced by the interest paid or incurred on the indebtedness that was converted to stock. If cash, new debt, or other property in addition to stock is transferred in settlement of debt, it would appear that only interest paid or accrued on the debt that was exchanged for stock would be used to reduce net operating losses. For example, if $10 cash, new debt with a value of $20, and stock with a value of $30 are transferred in settlement of a $100 debt, it appears that only interest (paid or accrued during the three prior years plus the current year up to the ownership change date) on 70 percent of the $100 debt would reduce the net operating loss.[148]

Similarly, in the case of an undersecured debt, only interest on the part of the debt that is considered unsecured and is exchanged directly for stock would be used to reduce the net operating loss.

(B) Change of Ownership within Two Years

As noted above, I.R.C. section 382(l)(5) deals harshly with taxpayers who undergo a second ownership change within two years of the first ownership change. Section 382(l)(5)(D) provides:

> If, during the two-year period immediately following an ownership change to which this paragraph applies, an ownership change of the new loss corporation occurs, this paragraph shall not apply and the section 382 limitation with respect to the second ownership change for any post-change year ending after the change date of the second ownership change shall be zero.

Prior to the issuance of regulations, a literal reading of the statute could have led one to conclude that the punitive provision is retroactive to the first ownership change. "This paragraph" refers to all of paragraph 382(l)(5): as the sentence specifically states that the entire paragraph "shall not apply," the bankruptcy exception would also not apply to the first ownership change. Thus, upon a second change of ownership within two years, there would be a section 382(a) limitation for the first ownership change and a section 382(a) limitation of zero for all years subsequent to the second ownership change.

Treas. Reg. section 1.382-9(n)(1) contains a provision that modifies the punitive result of section 382(l)(5)(D). Specifically, that regulation states:

> If section 382(l)(5) applies to an ownership change and, within the two-year period immediately following such ownership change, a second ownership change

[146] I.R.C. § 382(l)(5)(B).

[147] I.R.C. § 382(l)(5)(D).

[148] *Cf.* Rev. Rul. 92-52, 1992-2 C.B. 34. Alternatively, the proper view could be that only 50 percent of the debt was converted into stock, because only 50 percent of the consideration was stock, and only interest on 50 percent of the debt would reduce the net operating loss.

occurs, section 382(l)(5) cannot apply to the second ownership change and the section 382(a) limitation with respect to the second ownership change is zero.

The regulation makes clear that the special protection of I.R.C. section 382(l)(5) will apply to the first ownership change even though a second ownership change occurs within two years. The bankruptcy exception of I.R.C. section 382(l)(5) will not apply to the second ownership change and the loss corporation will have a section 382 limitation of zero for all postchange years after the second ownership change.

Therefore, if a loss corporation anticipates a second ownership change, in most circumstances the loss corporation would choose to elect out of I.R.C. section 382(l)(5). Unless the loss corporation is able to use its carryovers (i.e., net operating losses, investment tax credits, etc.) in the year prior to the second ownership change, without the election out of I.R.C. section 382(l)(5), such carryovers would be unusable any time thereafter. Also, there will be a disallowance of any recognition of a net unrealized built-in loss during the recognition period after the second ownership change.

(C) Continuity of Business Enterprise

In general, following an ownership change pursuant to I.R.C. section 382, a corporation must continue its business enterprise during the two-year period beginning on the change date. If a corporation does not continue its business enterprise for the requisite two-year period, the section 382(a) limitation is deemed to be zero.[149] If a corporation is subject to I.R.C. section 382(l)(5), however, the continuity of business enterprise requirement is waived.[150]

(iii) I.R.C. Section 382(l)(6)

(A) General Provisions

I.R.C. section 382(l)(5)(H) provides that a debtor in bankruptcy may elect not to have the section 382(l)(5) provisions apply. Regulations govern the manner in which the debtor makes this election.[151] In addition, even if I.R.C. section 382(l)(5) does not apply, section 382(l)(6) will apply if a corporation subject to a title 11 or similar case undergoes an ownership change.

The regulations provide that the election not to have the provisions of I.R.C. section 382(l)(5) apply is irrevocable. The regulations also require that the election be made on the return of the loss corporation for the tax year including or ending with the change date. Because the election is irrevocable, corporations are precluded from either making the election after a second ownership change or making a protective election that is revoked after the expiration of the two-year period.

Because the election will not have to be made until the due date of the return (including extensions), proper selection of the effective date can still give the taxpayer extended time in which to make the election not to apply I.R.C. section 382(l)(5).

I.R.C. section 382(l)(6) provides that the debtor may calculate the section 382 limitation based on the enhanced value of the corporation after the ownership

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[149] I.R.C. § 382(c).
[150] Treas. Reg. § 1.382-9(m)(1). *But see* Treas. Reg. § 1.269-3(d).
[151] Treas. Reg. § 1.382-9(i).

change occurs. Thus, the debtor would be able to use the value of the equity on emergence from chapter 11 rather than the value before debt was exchanged for stock.

(B) Determining Value under I.R.C. Section 382(l)(6)

As previously discussed, I.R.C. section 382(l)(6) provides a special rule for purposes of computing the value of the loss corporation under I.R.C. section 382(e), on which the section 382 limitation is based: The value under section 382(e) must be increased to "reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction."

Regulations under I.R.C. section 382 provide guidance on determining the value of a loss corporation that is emerging from bankruptcy and elects to apply the provisions of I.R.C. section 382(l)(6).[152]

The regulations provide that the value of the loss corporation for section 382 limitation purposes is the lesser of (1) the value of the loss corporation's stock immediately after the ownership change (the stock value test) or (2) the value of the loss corporation's assets (determined without regard to liabilities) immediately before the ownership change (the asset value test). Under the regulations, increases in the value of the loss corporation are treated as attributable to the conversion of the debt into stock (the stock value test).[153] These regulations provide appropriate adjustment for both the stock value and asset value tests.

If the value of the loss corporation's stock immediately after the ownership change exceeds the value that would have resulted had the loss corporation's creditors exchanged all of their debt for stock, the loss corporation's value is limited to an amount that approximates that lower value.

The regulations contain an antiabuse rule designed to prevent deliberate artificial increases in the value of the loss corporation attributable to stock that is not subject to risks of corporate business operations. Under the rule, the amount determined under the stock value test is reduced by the value of stock that is issued with a principal purpose of increasing the section 382 limitation without subjecting the investment to the entrepreneurial risks of corporate business operations.

Under the regulations, the value of stock of a loss corporation issued in connection with an ownership change in a title 11 or similar case cannot exceed the amount of cash plus the value of any property (including indebtedness of the loss corporation) received by the loss corporation in consideration for the issuance of that stock.

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[152] Treas. Reg. § 1.382-9(j)-(l).

[153] Treas. Reg. § 1.382-9(k). The regulations provide that in determining the value of the stock for this purpose, "stock" will include stock described in I.R.C. § 1504(a)(4) and stock not treated as stock under Treas. Reg. section 1.382-2T(f)(18)(ii), but will not include ownership interests treated as stock under Treas. Reg. section 1.382-2T(f)(18)(iii). This latter rule is contrary to the basic I.R.C. section 382 valuation rule, which includes in the stock value computation ownership interests treated as stock. These stock-treated-as-nonstock and nonstock-treated-as-stock rules formed the basis of a 1993 IRS objection to a liquidating bankruptcy plan in a case involving Integrated Resources, Inc. According to the IRS, the plan, as originally proposed, would have resulted in an ownership change even though no new stock would be issued. Following the IRS objection, the plan was withdrawn.

(C) Continuity of Business Enterprise

As stated above, the continuity of business enterprise requirement of I.R.C. section 382(c) is waived if a corporation is subject to section 382(l)(5); however, if a corporation is subject to section 382(l)(6), the continuity of business requirement must be met.[154]

(iv) Comparison of I.R.C. Section 382(l)(5) and (l)(6)

Exhibit 6.3 compares the use of the bankruptcy exception of I.R.C. section 382(l)(5) with the alternative of using the enhanced value of section 382(l)(6). Note that several factors must be considered in deciding whether to use the bankruptcy exception:

- The present value of the projected benefit from net operating losses allowable under the section 382 limitation should be compared with the present value of the benefit of the net operating loss remaining after determining the effect of I.R.C. section 382(l)(5).
- The extent to which the remaining net operating loss under the bankruptcy exception may be lost due to a change in ownership within two years should be carefully considered. If a change of ownership appears likely, then it may be best to elect not to apply the bankruptcy exception.
- Trading of claims prior to the confirmation of the plan may cause qualifying creditors and stockholders to own less than 50 percent of the reorganized debtor, and thus to fail the continuity requirement of I.R.C. section 382(l)(5).
- The investment of additional capital may result in the loss of significant tax benefits if new investors will own more than 50 percent of the equity. Thus, the potential tax benefit that may be lost if I.R.C. section 382(l)(5) is not applied should be compared with the benefit to the debtor of attracting additional capital.
- If discontinuation of the business within two years is planned, the section 382(l)(5) bankruptcy exception should generally be used.[155]

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[154] Treas. Reg. § 1.382-9(m)(2). *But see* Treas. Reg. § 1.269-3(d).

[155] Sniderman, How to Preserve Net Operating Loss (mimeographed) (Deloitte Touche, Pittsburgh, 1990) at 9—10. If there is an ownership change and the special bankruptcy rule of I.R.C. section 382(l)(5) applies, the continuity of business requirement is not applicable. Treas. Reg. § 1.382-9(m). In the absence of strong evidence to the contrary, however, an ownership change in bankruptcy to which I.R.C. section 382(l)(5) applies is considered to be made for tax avoidance under I.R.C. section 269, unless the bankrupt corporation "carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 case." Treas. Reg. § 1.269-3(d). A temporary cessation of activities can be overcome (and the above standard met) if the corporation continues to utilize a "significant amount of the historic business assets." Also, the decision regarding "more than an insignificant amount of an active business" is made without regard to continuity of business enterprise under Treas. Reg. section 1.368-1(d).

EXHIBIT 6.3

Comparison between Bankruptcy Exception and Enhanced Annual Limit for Debtors in Bankruptcy

Area of Comparison	Bankruptcy Exception (I.R.C. Section 382(1)(5))	Enhanced Annual Limit (I.R.C. Section 382(1)/6))
Further ownership changes	If second ownership change within 2 years, annual limit equals zero.	
	Transferability of stock issued in the reorganization may have to be partially restricted to prevent a second ownership change from occurring within 2 years of bankruptcy reorganization or else entire NOL may be lost.	N/A
Interest paid on debt converted to stock	Must reduce NOL by interest paid or accrued on debt converted to stock during the 3 years ending before the year of the ownership change.	N/A
Business continuity	Corporations qualifying for and using I.R.C. section 382(1)(5) must not fail to maintain at least "an insignificant amount of trade/business." (Less strict than I.R.C. section 382(l)(6) continuity requirement.)	If debtor discontinues as business within 2 years of the ownership change, the annual limit is zero. No NOL use will be allowed.
Necessity to stop trading in claims prior to plan confirmation	50% of stock in new loss company must be owned by old creditors/shareholders. Extensive trading in claims or stock may prevent the possibility of meeting this requirement.	N/A
	Transferability of stock issued in the reorganization may have to be partially restricted to prevent a second ownership change from occurring within 2 years of bankruptcy reorganization or else entire NOL may be lost.	N/A
Attracting new financing	Disadvantage because limited to giving 50% of equity to new investors.	May give greater than 50% of equity to new investors.

Source: Howard I. Sniderman, Molly A. Gallagher, James H. Joshowitz, "A Tax Overview of Troubled Company Debt Restructuring," *The Tax Adviser*, April 1990, p. 212. Reprinted with permission from *The Tax Adviser*. Copyright © 1990 by American Institute of Certified Public Accountants, Inc.

Thus, a loss corporation needs to review carefully its overall tax situation to determine whether I.R.C. section 382(l)(5) is the most beneficial route to take. Particular attention must be paid to the corporation's pre-bankruptcy interest expense and any forgiveness of indebtedness income that will arise as a result of its bankruptcy.

(h) Built-In Gains and Losses

(i) In General

As noted above, the section 382 limitation applies to prechange losses. Prechange losses include (1) the net operating loss carryforward to the beginning of the year in which the ownership change occurs, (2) the portion of the net operating loss allocable (determined on a daily pro rata basis) to the period in the year of the ownership change that occurs before such change date, plus (3) certain "built-in" losses.[156] Thus, certain built-in losses are subject to the same restrictions as net operating losses. In general, if a loss corporation has a net unrealized built-in loss on the change date, any built-in loss recognized during the five-year period following the ownership change date will be treated as a pre-change loss. And, a recognized built-in loss that is disallowed for any postchange year may be carried forward as if it were a net operating loss carryover, subject to the section 382 limitation.[157] Conversely, in general, if a loss corporation has a net unrealized built-in gain on the change date, a built-in gain recognized during the five-year period following the ownership change date can increase the section 382 limitation (and, in effect, permit the loss corporation to offset more income with prechange losses).

Built-in gains and losses are defined generally in I.R.C. section 382(h)(3), as the difference between the fair market value of the loss corporation's assets and the tax basis of those assets determined immediately before the ownership change. A number of special rules modify this general calculation.[158] If the amount (either gain or loss) is not greater than the lesser of: (1) 15 percent of the fair market value of the corporation's assets or (2) $10 million, then the net unrealized gain or loss is zero. Cash, cash equivalent items, and marketable securities are generally excluded from this de minimis computation.[159] If the ownership change occurs in connection with a redemption, the net unrealized built-in gain (or loss) is determined after the redemption.[160] Finally, if 80 percent or more in value of the stock of a corporation is acquired in one transaction (or a series of transactions within a 12-month period), the determination of fair market value for purposes of computing net unrealized built-in loss cannot exceed the grossed-up amount paid for the stock, adjusted for indebtedness.[161]

Example 6.25

The assets of X Corporation on January 1, 2000 (the date all its stock is sold for $1,500), are indicated below. Assume that the long-term tax-exempt rate is 6 percent and that X earns $200 during 2000 and in each of the next 4 years. X has no net operating loss carryovers.

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[156] I.R.C. § 382(d).
[157] I.R.C. § 382(h)(4).
[158] *See* discussion *infra* § 6.4(h)(ii) regarding I.R.C. § 382(h)(6) and Notice 2003-65.
[159] *See* I.R.C. § 382(h)(3)(B).
[160] I.R.C. § 382(h)(3)(A)(ii).
[161] I.R.C. § 382(h)(8).

	Value	Basis	Unrealized Gain (Loss)
Inventory	$ 100	$ 500	$ (400)
Equipment	300	600	(300)
Leasehold	100	500	(400)
Land	1,000	400	600
	$1,500	$2,000	$ (500)

The unrealized loss of $500 on the change date (January 1, 2000) meets the threshold requirement, because it exceeds 15 percent of the fair market value of the assets ($1,500) or $225. Therefore, there is a net unrealized built-in loss of $500.

Assume that on March 1, 2000, the inventory with a basis of $500 is sold for $75, and on March 1, 2003, the land is sold at a gain of $450. The $425 loss on the inventory is a recognized built-in loss to the extent of $400 (the lesser of the loss on the actual sale date or the change date). Such recognized built-in loss is subject to the section 382 limitation. The $450 gain on the sale of the land is a recognized built-in gain. It does not increase the section 382 limitation, however, because there was a net unrealized built-in loss on the change date (not a net unrealized built-in gain).

Assume further that on August 1, 2004, the equipment is sold at a loss of $250. That loss is a recognized built-in loss to the extent of $100. The inventory previously generated a recognized built-in loss of $400, and the sum of the individual recognized built-in losses cannot exceed the net unrealized built-in loss on the change date, or $500.

Therefore, the benefit of increasing the section 382 limitation for recognized built-in gains (or the detriment of subjecting built-in losses to the section 382 limitation) is always subject to two limitations: (1) the amount of the gain or loss that is built in to a specific asset on the change date (specific asset limitation) and (2) the corporation's aggregate built-in gain or loss position taking into account gains and losses that are built in to all of its assets as well as certain items of income and deduction (overall asset limitation).

If the $250 loss on the equipment pertained to equipment acquired during 2000, then the entire $250 loss would be recognized and would not be subject to any limitation under section 382.

The section 382 limitation is $90 ($1,500 value × 6 percent long-term tax-exempt rate) for each year. Thus, the $400 recognized built-in loss in 2000 is deductible to the extent of $90. Likewise, the $100 recognized built-in loss in 2001 is also deductible from income to the extent of $90. If X had a net operating loss carryover on January 1, 2000, the built-in loss would be used first against the section 382 limitation of $90 in the year of the loss. Current losses are always used before net operating loss carryovers. Thus, no portion of the carryover loss would be deductible.

(ii) I.R.C. Section 382(h)(6)

I.R.C. Section 382(h)(6) expands the definition of a recognized built-in gain or loss to include items of income or deduction that are taken into account during the recognition period but are "attributable to periods" before the ownership change date. In addition, the definition of net unrealized built-in gain or loss is modified to take into account these items of built-in income or deduction, regardless of whether they are included in the recognition period. Specifically, the language of I.R.C. section 382(h)(6) is as follows:

(6) Treatment of certain built-in items.

(A) Income items. Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account.

(B) Deduction items. Any amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction.

(C) Adjustments. The amount of the net unrealized built-in gain or loss shall be properly adjusted for amounts which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period.

(A) Legislative History

As originally enacted as part of the Tax Reform Act of 1986, I.R.C. section 382(h)(6) only pertained to built-in deductions and provided that "[t]he Secretary may by regulation treat amounts which accrue before the change date but which are allowable as a deduction on or after such date as recognized built-in losses."[162] In 1988, Congress substantially modified Section 382(h)(6) with the enactment of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).[163] Congress adopted the phrase "attributable to periods" in lieu of "accrue" to describe built-in deduction items and employed the same new language to describe built-in income items.[164]

The legislative history of I.R.C. section 382(h)(6) provides examples of built-in items of deduction and income. The examples of "accrued deductions" include deductions deferred under I.R.C. section 267 and/or I.R.C. section 465.[165] Examples of built-in income items include gain on the completion of a long-term contract performed by a taxpayer using the completed contract method, I.R.C. section 481 adjustments, and accounts receivable held by a cash basis taxpayer.[166]

I.R.C. section 267(a)(1) generally places a limitation upon losses incurred in connection with sales between related persons. I.R.C. section 267(a)(2) generally places a limitation upon the ability of a taxpayer using the accrual method of accounting to deduct expenses accrued to related persons who use the cash method of accounting. I.R.C. section 465 generally limits the ability of certain taxpayers to deduct losses incurred in connection with activities financed by certain non-recourse borrowings. Both I.R.C. section 267 and I.R.C. section 465 apply in situations in which a loss or deduction would otherwise be allowable under general tax principles. These provisions apply to closed and completed

[162] Tax Reform Act of 1986, Pub. L. No. 99-514, § 621, 100 Stat. 2085, 2259, 99th Cong., 2d Sess. (1986).

[163] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1006(d), 102 Stat. 3395, 100th Cong (1988).

[164] *Id.*

[165] H. Rep. No. 841, 99th Cong., 2d Sess., at II-191 (1986).

[166] H. Rep. No. 795, 100th Cong., 2d Sess., at 46 (1988).

transactions. Similarly, installment gains, I.R.C. section 481 adjustments, and accounts receivable and payable held by a cash basis taxpayer are also examples of "closed" and completed transactions.

The examples of built-in income and deduction in the legislative history satisfy the fundamental tax accrual standards of I.R.C. sections 451 and 461. Both of these standards are based on the "all events" test. This standard is met when all events have occurred that (1) fix the right to receive the income or that determine the fact of the liability; and (2) the amount at issue can be determined with reasonable accuracy. Economic performance, if necessary for I.R.C. section 382 purposes, would also have occurred. Therefore, it is difficult to determine from the legislative history of I.R.C. section 382 whether "attributable to" requires tax accrual, economic accrual, or both. What is also not clear from the legislative history is whether an item that is contingent and requires some future event to occur to fix the liability and the amount of the liability (other than payment or the passage of time), should be considered a built-in item for purposes of I.R.C. section 382(h)(6)(B).

(B) IRS Rulings

Prior to the issuance of Notice 2003-65,[167] which is discussed below, there was little administrative guidance relating to what constitutes a built-in item under I.R.C. section 382(h)(6). In Technical Advice Memorandum 199942003,[168] an accrual method taxpayer received prepaid service income prior to the date of an ownership change ("change date") as contemplated by I.R.C. section 382. The taxpayer elected to defer reporting the prepaid income pursuant to Revenue Procedure 71-21.[169] Revenue Procedure 71-21 permits accrual method taxpayers to elect to defer reporting such payments as income until the time that services are performed, provided that performance occurs no later than the tax period immediately following the one in which payments are received. The taxpayer reported the prepaid amounts as income on its federal tax return for the period immediately following the "change date." The IRS ruled that the taxpayer, according to its method of accounting, properly reported the prepaid amounts in income in the period subsequent to the "change date" and that "the mere fact that [the t]axpayer actually received the prepaid amounts during the pre-change period does not, under these circumstances, require that such amounts be treated as items of income attributable to the pre-change period for purposes of treatment as [recognized built-in gain under I.R.C. section 382(h)(6)(A)] when the income is later recognized." The IRS seems to have based its conclusion on the fact that although the amount in question could be determined with reasonable accuracy, the taxpayer did not provide any services with respect to the prepaid amounts prior to the "change date" and, therefore, the amounts were not economically accrued and attributable to the period prior to the "change date."

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[167] 2003-40 I.R.B. 1.
[168] (July 6, 1999).
[169] Rev. Proc. 71-21, 1971-2 C.B. 549.

In Private Letter Ruling 9444035,[170] an acquiring corporation purchased stock of a target corporation on various dates, causing an ownership change under I.R.C. section 382. Some of the stock was acquired on the New York Stock Exchange and some of the stock was acquired directly from shareholders. After the change date, and to facilitate the acquisition of the remaining portion of the underlying stock by the acquiring corporation, a seller ("Seller") exercised non-statutory stock options that the Seller previously received from target for services performed. The IRS, citing I.R.C. section 382(h)(5)(A) and I.R.C. section 382(h)(6)(B), ruled that any deduction by the target corporation attributable to the seller's exercise of the stock options should be treated as a recognized built-in loss for the taxable year for which it was allowable as a deduction.

The IRS's conclusion suggested that it did not follow tax accrual concepts for determining what is a built-in item. The IRS ruled that *any* deduction resulting from the exercise of the stock options issued prior to the change date is a built-in deduction. This may indicate that the performance of work by the employees and the granting or vesting of the options is all that was necessary to make the deduction a built-in item, at least in the eyes of the IRS. The fact that the option may never have been exercised or the amount of the deduction may have not been determined at the time of the ownership change may have been viewed as irrelevant by the IRS.

Finally, in Notice 87-79,[171] the IRS announced that it anticipated regulations that would permit taxpayers to allocate to the pre-change period any discharge of indebtedness (DOI) income that was integrally related to a transaction that resulted in an ownership change. This approach was confirmed by Private Letter Ruling 9312006,[172] in which the built-in discharge of indebtedness income was specifically limited to the amount of income that would have been included if discharge of indebtedness income occurred on the change date.

(C) Notice 2003-65

In September 2003, the IRS released Notice 2003-65, providing guidance on the identification of built-in items under I.R.C. section 382(h). Notice 2003-65 discusses two alternative approaches for the identification of built-in items for purposes of I.R.C. section 382(h): (1) the "1374 approach," which identifies built-in items by incorporating the rules of I.R.C. section 1374 (which generally pertain to the imposition of entity-level tax on net realized built-in gains of a subchapter S corporation), and (2) the "338 approach," which identifies built-in items by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if an I.R.C. section 338 election had been made with respect to a hypothetical purchase of all the outstanding stock of the loss corporation on the ownership change date. Notice 2003-65 provides that, although the alternative approaches serve as "safe har-

[170] (Aug. 5, 1994).
[171] 1987-2 C.B. 387.
[172] (Dec. 19, 1992). *See also* Private Letter Ruling 9616027 (Jan. 19, 1996); Private Letter Ruling 9444035 (Aug. 5, 1994).

bors," they are not the exclusive methods by which a taxpayer may identify built-in items for purposes of I.R.C. section 382(h).

Generally, the I.R.C. section 1374 approach treats items of income or deduction as attributable to the pre-change period, if such items accrue for tax purposes prior to the ownership change. The 1374 approach generally incorporates the rules of I.R.C. section 1374(d) and the Treasury Regulations to calculate net unrealized built-in gain and net unrealized built-in loss and to identify recognized built-in gain and recognized built-in loss. Under the 1374 approach, net unrealized built-in gain or net unrealized built-in loss is the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation (to an unrelated buyer who assumed all of the loss corporation's liabilities) immediately before the ownership change. This net amount of gain or loss that would be recognized is calculated by beginning with the hypothetical amount realized, adjusted as follows:

- Decreased by the sum of any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale,
- Decreased by the loss corporation's aggregate adjusted basis in all of its assets,
- Increased or decreased by the corporation's I.R.C. section 481 adjustments that would be taken into account on a hypothetical sale, and
- Increased by any recognized built-in loss that would not be allowed as a deduction under I.R.C. section 382, 383, or 384 on the hypothetical sale.

A positive numerical total is the loss corporation's net unrealized built-in gain; a negative result is the loss corporation's net unrealized built-in loss. The amount of gain or loss recognized during the recognition period on the sale or exchange of an asset is recognized built-in gain or recognized built-in loss. The recognized built-in gain or recognized built-in loss attributable to an asset cannot exceed the unrealized built-in gain or loss in that asset on the change date.

For example, suppose that immediately before an ownership change, Lossco has an asset with a fair market value of $100 and a basis of $10, and a deductible liability of $30. Applying the 1374 approach, Lossco would have a $60 net unrealized built-in gain ($100, the amount Lossco would realize if it sold all its assets to a third party that assumed all of its liabilities, decreased by $40, the sum of the deductible liability ($30) and the basis in the asset ($10)).

In cases other than sales and exchanges, the 1374 approach generally relies on the accrual method of accounting to identify income or deduction items as recognized built-in gain or recognized built-in loss. Items of income or deduction properly included in income or allowed as a deduction during the recognition period are generally considered "attributable to periods before the change date" and are treated as recognized built-in gain or recognized built-in loss if an accrual method taxpayer would have included the item in income or been allowed a deduction for the item before the change date. Note, however, that in determining whether an item is a recognized built-in loss, "accrual" will be deemed to have occurred even if the "economic performance" rules of I.R.C.

section 461(h) have not been satisfied (e.g., a fixed liability will be treated as accrued even if it has not yet been paid). In general, the 1374 approach is best for taxpayers who want to avoid characterization of deductions as built-in losses (e.g., for loss corporations with contingent liabilities).

The 338 approach generally identifies items of recognized built-in gain and recognized built-in loss by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if an I.R.C. section 338 election had been made with respect to a hypothetical purchase of all the outstanding stock of the loss corporation on the change date. As a result, unlike under the 1374 approach, under the 338 approach, built-in gain assets may be treated as generating recognized built-in gain even if they are not disposed of at a gain during the recognition period, and deductions for liabilities, in particular contingent liabilities, that exist on the change date may be treated as recognized built-in loss. Thus, in general, the 338 approach is best for taxpayers that want to treat income from wasting assets as recognized built-in gain. Under the section 338 approach, the net unrealized built-in gain or net unrealized built-in loss is calculated in the same manner as it is under the 1374 approach. Accordingly, unlike the case in which an I.R.C. section 338 election is actually made, contingent consideration (including a contingent liability) is taken into account in the initial calculation of net unrealized built-in gain or net unrealized built-in loss, without further adjustments to reflect subsequent changes in deemed consideration.

For example, suppose that immediately before an ownership change, Lossco has one asset with a fair market value of $100 and a basis of $10 and a deductible contingent liability estimated at $40. Applying the 338 approach, Lossco has a $50 net unrealized built-in gain ($100, the amount Lossco would realize if it sold all of its assets to a third party that assumed all of its liabilities, decreased by $50, the sum of the deductible liability ($40) and the basis of asset ($10)). If, during Year 1 of recognition period, a final legal determination fixes the contingent liability at $10, the net unrealized built-in gain is not readjusted to reflect the resolution of the amount of the contingent liability.

As stated above, the 338 approach may be best for taxpayers that want to treat income from wasting assets as recognized built-in gain. The section 338 approach assumes that for any tax year, any asset that has a built-in gain on the change date generates income equal to the cost recovery that would have been allowed for such asset under the applicable code section if an I.R.C. section 338 election had been made with respect to the hypothetical purchase. The approach treats as a recognized built-in gain an amount equal to the excess of the cost recovery that would have been allowable with respect to such asset had an I.R.C. section 338 election been made for the hypothetical purchase, over the loss corporation's actual cost recovery. The cost recovery with respect to the hypothetical purchase will be based on the asset's fair market value on the change date and a cost recovery period that begins on the change date. The excess amount is a recognized built-in gain, regardless of the loss corporation's actual gross income in any specific taxable year during the recognition period. For example, suppose Lossco has a $300 net unrealized built-in gain attributable to goodwill

with a fair market value of $300 and a basis of $0. In Year 1 of the recognition period, Lossco could amortize 1/15th of the $300 basis in goodwill ($20) if the hypothetical I.R.C. section 338 election were made. Lossco's actual amortization deduction for goodwill will be zero. As a result, Lossco is treated as having $20 of recognized built-in gain and may increase its section 382 limitation by $20.

Notice 2003-65 provides that taxpayers may rely on the 1374 approach or the 338 approach for purposes of applying I.R.C. section 382(h) to an ownership change that occurs any time prior to the effective date of temporary or final regulations yet to be issued under I.R.C. section 382(h).

Notice 2003-65 provides a number of special rules relating to the treatment of DOI income as a built-in item under the two methods. Under the 1374 approach, any DOI income *included* in gross income under I.R.C. section 61(a)(12) during the first 12 months of recognition period is recognized built-in gain if it arises from a debt owed by a loss corporation at beginning of the recognition period.[173] For example, suppose the loss corporation has a $300 net unrealized built-in gain attributable, in part, to an asset with a fair market value of $200 and a basis $150, and that the asset is subject to a debt with an adjusted issue price of $100.

During Year 1 of the recognition period, the loss corporation satisfies the debt by paying the lender $60; the $40 of DOI income the loss corporation recognizes in Year 1 is recognized built-in gain for that year. In Year 2, the loss corporation sells the asset for $200; the $50 of gain recognized on the sale of the asset is recognized built-in gain in Year 2. Any DOI income *excluded* under I.R.C. section 108(a) is not treated as recognized built-in gain. However, any basis reduction under I.R.C. sections 108(b)(5) and 1017(a) is treated as occurring immediately before the ownership change for purposes of determining whether a recognized gain or loss is a recognized built-in gain or a recognized built-in loss under I.R.C. section 382(h)(2). The basis reduction does not affect the loss corporation's net unrealized built-in gain or net unrealized built-in loss under I.R.C. section 382(h)(3). For example, suppose the facts are the same as above, except that $40 of the debt is discharged in a title 11 case and is excluded under I.R.C. section 108(a). The loss corporation will reduce the tax basis of the asset from $150 to $110 under I.R.C. sections 108(b)(5) and 1017(a). The $40 of excluded DOI income in Year 1 is not recognized built-in gain. Because basis reduction is treated as having occurred immediately before the ownership change for purposes of I.R.C. section 382(h)(2), the $90 of gain recognized on sale of the asset is recognized built-in gain in Year 2.

Under the 338 approach, any DOI income *included* in gross income under I.R.C. section 61(a)(12) and attributable to any of the loss corporation's prechange debt is recognized built-in gain in an amount not exceeding the excess, if any, of adjusted issue price of the discharged debt over the fair market value of

[173] Taxpayers that otherwise follow the 1374 approach may apply Notice 87-79 for ownership changes before September 12, 2003. There is also a parallel rule for treating a bad debt deduction under section 166 as recognized built-in loss if the deduction arises from a debt owed to the loss corporation at the beginning of recognition period.

the debt on change date.[174] Any DOI income that is *excluded* under I.R.C. section 108(a) is not treated as recognized built-in gain. However, any basis reduction under I.R.C. sections 108(b)(5) and 1017(a) that occurs during recognition period is treated as having occurred immediately before the ownership change for purposes of I.R.C. section 382(h)(2) to the extent of the excess, if any, of adjusted issue price of debt over its fair market value on the change date. The reduction in tax basis does not affect the loss corporation's net unrealized built-in gain or net unrealized built-in loss under I.R.C. section 382(h)(3).

For example, suppose the loss corporation has a $300 net unrealized built-in gain attributable, in part, to an asset (with a fair market value of fair market value $200, and a basis of $150) that is subject to a debt with adjusted issue price of $100 and a fair market value of $60. During Year 2 of the recognition period, the loss corporation satisfies the debt for $60 and $40 of debt is discharged in a title 11 case. The loss corporation excludes $40 of DOI income under I.R.C. section 108(a) and reduces the tax basis of the asset under I.R.C. sections 108(b)(5) and 1017(a) to $110. The $40 of excluded DOI income is not recognized built-in gain. In Year 3, when the tax basis of the asset is still $110, the loss corporation sells the asset for $200 and recognizes $90 of gain. If an I.R.C. section 338 election had been made with respect to a hypothetical purchase of the loss corporation's stock, the loss corporation would have recognized $0 of gain on the sale, because the loss corporation's basis in the asset would have been $200 at the time of its sale. Thus, the loss corporation has a $90 recognized built-in gain from the sale of the asset (excess of the actual $90 of gain over the $0 of gain the loss corporation would have recognized had an election under I.R.C. section 338 been made). Thus, the loss corporation's section 382 limitation for Year 3 is increased by $90.

§ 6.5 I.R.C. SECTION 383: CARRYOVERS OTHER THAN NET OPERATING LOSSES

(a) General Provisions

Paralleling the "section 382 limitation" on the use of net operating loss carryovers, I.R.C. section 383 limits the amount of excess credits (including unused I.R.C. section 39 general business credits and unused I.R.C. section 53 minimum tax credits), net capital loss carryovers, and foreign tax credits that can be used in any post-ownership-change year. Under regulations adopted on June 26, 1991,[175] effective for ownership changes occurring after December 31, 1986, capital losses used to offset capital gains reduce the section 382 limitation amount.

In addition, a separate "section 383 limitation" (applicable to credit carryovers) is computed by determining the difference between the corporation's income tax net of allowable net operating loss carryovers, and a hypothetical income tax that would be payable if the corporation were entitled to deduct the

[174] As with the section 1374 approach, taxpayers that otherwise follow the section 338 approach may apply Notice 87-79 (rather than the rules of the 338 approach) to DOI income for ownership changes before Sept. 12, 2003.

[175] T.D. 8352, 1991-2 C.B. 67.

amount of any unused section 382 limitation.[176] This difference is the maximum credit that can be used to offset tax in a given post-ownership-change year.

Finally, the section 383 regulations establish a "section 383 credit reduction amount," which reduces the unused section 382 limitation amount that can be carried over. Because the section 383 limitation limits credits against tax (as opposed to reductions in taxable income), the section 383 credit reduction amount must be computed by "grossing up" the tax amounts to arrive at the appropriate taxable income amounts.[177]

§ 6.6 I.R.C. SECTION 384

(a) Introduction

I.R.C. section 382 limits the amount of post-ownership-change income that can be used against the losses of a loss corporation that experiences an ownership change. I.R.C. section 384 enacted as part of the Omnibus Budget Reconciliation Act of 1987, precludes a loss corporation (whether or not it experiences any ownership change) from offsetting its loss against any built-in gain from a "gain corporation."[178]

(b) Overview

I.R.C. section 384 resembles I.R.C. section 382 with respect to its ultimate result: limitation on use of preacquisition losses. I.R.C. section 382 becomes operational when a loss corporation has an ownership change. I.R.C. section 384 is triggered when one corporation acquires control of another corporation or its assets (in certain transactions), and either corporation is a gain corporation.

I.R.C. section 384 limits the use of any built-in gain existing at the time of the acquisition, but not recognized until after the acquisition, against a preacquisition loss other than that of the gain corporation. Thus, a preacquisition loss (from other than the gain corporation) cannot be used to offset the recognition of a built-in gain after the acquisition.

A recognized built-in gain is a gain recognized after the acquisition on the disposition of an asset that was held on the acquisition date, and whose fair market value exceeded its adjusted basis on that date, as well as certain items of income that are attributable to periods before the acquisition date.[179] For a built-in gain to exist on the acquisition date, the amount of net unrealized built-in gains must exceed 15 percent of the fair market value of a corporation's assets, or $10 million, whichever is lower, immediately before the ownership change.[180]

The provisions of I.R.C. section 384 apply independently of, and in addition to, the limitations of I.R.C. section 382. The section 384 limitations apply to

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[176] *See* Treas. Reg. § 1.383-1(c)(6)(ii), Ex.
[177] *See* Treas. Reg. § 1.383-1(e)(3), -(e)(4), and (f), Exs.
[178] I.R.C. § 384 as enacted by Pub. L. No. 100-203, § 10226, is generally effective for transactions with acquisition dates after December 15, 1987.
[179] I.R.C. § 384(c)(1)(A).
[180] I.R.C. § 384(c)(8).

excess credits and net capital losses in addition to preacquisition net operating losses.[181]

I.R.C. section 384 gives the IRS regulatory authority to issue regulations, but no such regulations have been issued.[182] Until the guidance of regulations is received, numerous complex issues will remain unresolved.

EXAMPLE 6.26

Assume that Corporation L, which is owned by individual A, has a net operating loss of $1,000,000 that expires in 2006. On April 1, 1999, L buys 100 percent of the stock of Corporation T for $2,500,000 from unrelated individual B. Included among T's assets is land with an adjusted basis of $250,000 and a value of $1,250,000 (both as of the acquisition date). After the acquisition, L and T file a consolidated federal income tax return. On October 1, 1999, T sells its land to unrelated P for $1,250,000 cash. Assuming the net unrealized built-in gains exceed the 15 percent/$10 million threshold, the recognition of the $1,000,000 built-in gain from the sale of land cannot be offset by the $1,000,000 net operating loss carryover of L, because it is classified as a preacquisition loss.

(c) Applicable Acquisitions

I.R.C. section 384 applies if two requirements are satisfied: (1) one corporation must acquire control of another corporation (or must acquire the assets of another corporation in a specified transaction), and (2) one of the corporations must be a gain corporation. The acquisition of control of another corporation can occur directly or through one or more corporations.[183] Control is defined as the ownership of a corporation's stock (possessing at least 80 percent of the total voting power of the stock and at least 80 percent of the total value of the stock of the corporation).[184] An acquisition of assets qualifies if the assets are acquired in an "A," "C," or "D" reorganization.

The limitations of I.R.C. section 384 do not apply to preacquisition losses if the gain and loss corporations were both members of the same controlled group at all times during the five years prior to the acquisition date.[185] A controlled group of corporations includes a parent-subsidiary controlled group connected through stock ownership with a common parent that owns 50 percent of the voting power and value of the stock, and a brother-sister controlled group connected through stock ownership by five or fewer persons who own at least 50 percent of the voting power and value of the stock. If the gain corporation has not been in existence for five years, the period of existence is substituted for five years.

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[181] I.R.C. § 384(d).
[182] I.R.C. § 384(f).
[183] I.R.C. § 384(a)(1).
[184] I.R.C. §§ 384(c)(5), 1504(a)(2). Certain preferred stock is excluded in making this determination. I.R.C. 1504(a)(4).
[185] I.R.C. § 384(b).

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) clarifies that the limitation in I.R.C. section 384 applies to any successor corporation to the same extent the limitation applied to the predecessor corporation.[186] Thus, a subsequent merger or liquidation of the two corporations will not avoid the limitation.

EXAMPLE 6.27

If Corporation L, which has net operating loss carryovers, acquires control of Corporation T, which has net unrealized built-in gains in excess of the 15 percent/$10 million threshold, and two years after the acquisition T liquidates into L under I.R.C. section 332, the section 384 limitation is not avoided for post-liquidation years. The built-in gains of T still must be tracked and cannot offset the preacquisition loss of L if they are recognized within the five-year period.

(d) Built-In Gains

Preacquisition losses are not allowed to offset built-in gains recognized upon a disposition of an asset during the five-year period after the acquisition.[187] For the definition of built-in gain, the code references I.R.C. section 382.

A net unrealized built-in gain is the amount by which the fair market value of all the assets of a corporation exceeds the aggregate adjusted basis of those assets.[188] The net unrealized built-in gain must exceed 15 percent of the fair market value of the assets, or $10 million, whichever is lower. If this threshold is not met, the net unrealized built-in gain is considered to be zero.[189]

The amount of recognized built-in gains that are not allowed to be offset by preacquisition losses is limited to total net unrealized built-in gains reduced by recognized built-in gains previously recognized during the five-year recognition period (overall limitation), as well as by gain that is built in with respect to the specific asset (specific asset limitation).[190]

After an asset or a stock acquisition, taxpayers will have to maintain records and make difficult valuation decisions regarding the inherent unrealized gain in all assets in the gain corporation on the acquisition date.[191] Upon a subsequent sale, taxpayers will have to ascertain how much of the recognized gain is attributable to preacquisition and postacquisition appreciation (only the former is precluded from being offset by the acquiring corporation's losses). Moreover, after an asset acquisition, taxpayers will have to maintain divisional records to

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[186] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 2004(m)(1)(B), 102 Stat. 3606, 100th Cong., 2d Sess. (1988) (adding I.R.C. § 384(c)(7)).

[187] I.R.C. § 384(c)(1).

[188] I.R.C. § 382(h)(3)(A).

[189] I.R.C. § 382(h)(3)(B).

[190] I.R.C. §§ 384(c)(1)(A) and (C).

[191] Inventory valuations will be important in determining whether the threshold 15 percent appreciation is satisfied. Questions remain about whether inventory should be valued at retail, wholesale, or replacement cost, and with or without taking into account the costs of disposition.

separate subsequent sales of assets at a gain that are attributable to property owned by the old preacquisition gain corporation.

In addition to built-in gain on assets, items of income that are properly attributable to periods before the acquisition date are treated as built-in gain.[192] In Notice 2003-65, the Service requested comments regarding whether different standards should apply to determine built-in items for section 384.

EXAMPLE 6.28

Assume that Corporation L acquires the stock of Corporation T on July 1, 1999, in a transaction to which I.R.C. section 384 applies. L and T file a consolidated federal income tax return. L has a $2,000,000 net operating loss carryover; T has net unrealized built-in gains of $500,000. The fair market value of T's assets immediately prior to the acquisition is $10,000,000 and includes no cash or cash equivalents. The built-in gain of $500,000 is ignored because it does not exceed 15 percent of the fair market value of T's assets ($500,000 not greater than $10,000,000 × 15 percent). Thus, the gain from a sale on December 1, 1999, of an asset with a built-in gain can be offset by L's preacquisition losses with no section 384 limitation.

EXAMPLE 6.29

Assume the same facts as in Example 6.28, except that T has net unrealized built-in gains of $3,000,000. The $3,000,000 of built-in gains exceeds the threshold limitation ($3,000,000 greater than $10,000,000 × 15 percent) and thus, no recognized built-in gain (up to $3,000,000) can be offset by any preacquisition loss of L.

EXAMPLE 6.30

Assume the same facts as in Example 6.29. Assume further that the net unrealized built-in gain was determined as follows:

Fair Market Value Asset	Adjusted Basis	Net Unrealized Immediately Prior to Acquisition	Built-In Gains
Land parcel 1	$100,000	$2,000,000	$1,900,000
Land parcel 2	900,000	500,000	(400,000)
Land parcel 3	500,000	1,600,000	1,100,000
Inventory	600,000	1,000,000	400,000
			$3,000,000

If land parcel 1 is sold by T on December 1, 1999, for $2,200,000, the built-in gain of $1,900,000 cannot be offset by the preacquisition loss of L. The remaining $200,000 of gain has accrued since the acquisition and thus can be offset by a preacquisition loss of L. If the inventory on hand at the acquisition date is all sold prior to the year-end, the $400,000 recognized built-in gain on inventory sales cannot be offset by any preacquisition loss of L. If, on December 31, 2000, T sells land parcel 3 for $2,000,000

[192] I.R.C. § 384(c)(1)(B).

and still holds land parcel 2, the $400,000 gain that accrued after the acquisition can be offset by T's preacquisition loss. On December 31, 2000, $2,300,000 of the net unrealized built-in gains has been recognized and not allowed to be offset by L's preacquisition loss. Thus, only $700,000 ($3,000,000 – $2,300,000) of the $1,100,000 recognized built-in gain from the sale of land parcel 3 cannot be offset by L's preacquisition loss.

(e) Preacquisition Loss

A preacquisition loss cannot offset recognized built-in gains. A preacquisition loss includes any net operating loss carryover to the taxable year in which the acquisition date occurs, to the extent such loss is allocable to the period in such year on or before the acquisition date.[193] For purposes of allocating the loss for the acquisition year, the loss is generally allocated ratably to each day in the year.[194] If a corporation has a net unrealized built-in loss (as defined for purposes of I.R.C. section 382), the preacquisition loss should include any recognized built-in loss.

Example 6.31

Assume that Corporation L acquires the stock of Corporation T on September 1, 1999, in a transaction to which I.R.C. section 384 applies. L has a net operating loss carryover from prior years of $3,500,000. L incurs a loss for the 1999 calendar year of $1,200,000. L's 1999 loss must be allocated ratably by day to the pre- and postacquisition periods ($1,200,000 × 243/365 = $798,904.11). Thus, L's preacquisition loss equals $4,298,904.11 ($3,500,000 + $798,904.11).

§ 6.7 I.R.C. SECTION 269: TRANSACTIONS TO EVADE OR AVOID TAX

(a) Introduction

I.R.C. section 269 was designed to prevent the distortion through tax avoidance of the deduction, credit, or allowance provisions of the code, primarily by corporations with large excess profits that acquire corporations with current, past, or prospective losses.

I.R.C. section 269(a) applies if:

- Any person or persons acquire, directly or indirectly, control of a corporation; *or*
- Any corporation acquires, directly or indirectly, property of another corporation not controlled, directly or indirectly, immediately before the acquisition by the acquiring corporation or its stockholders; and the

[193] I.R.C. § 384(c)(3)(A).

[194] *But see* Private Letter Ruling 200238017 (June 11, 2002) (allowing allocation of the loss based on a closing-of-the-books).

acquiring corporation's basis for the property is determined by reference to the transferor corporation's basis;[195] *and*

- The principal purpose of the acquisition is evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or allowance which such person or corporation could not otherwise obtain.

I.R.C. section 269(b) applies if:

- There is a qualified stock purchase[196] by a corporation of another corporation;
- An election is not made under I.R.C. section 338 with respect to the qualified stock purchase;
- The acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than two years after the acquisition date; and
- The principal purpose for the liquidation is evasion or avoidance of federal income tax.

(i) Definition of Terms

"Control" is defined in I.R.C. section 269(a) as the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of voting stock, *or* at least 50 percent of the total value of shares of all classes of the corporation's stock. Because the code makes no provision for the I.R.C. section 318 attribution rules, they are not applied in determining ownership, although the statute's use of "indirect" could bring some deemed ownership into play.[197] And, control could result indirectly from the reduction of ownership by other shareholders as well as directly through stock purchases.[198]

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[195] Note that because I.R.C. section 269(a)(2) applies to a purchase of property from a corporation "not controlled" by the acquiror, the disallowance of I.R.C. section 269 can be avoided if the acquisition is from a corporation that *is* controlled by the acquiring corporation or its shareholders. This common control exception permits a profitable corporation and a loss corporation owned by the same person or persons to merge without risking an I.R.C. section 269 disallowance of a net operating loss deduction. Recent legislative initiatives have included proposals to remove the acquisition of control requirement and the common control exception from I.R.C. sections 269(a)(1) and 269(a)(2), respectively. *See, e.g.*, Section 325 of the Jobs and Growth Tax Relief Act of 2003 (Senate Bill 1054). *See also* The Jumpstart Our Business Strength Act (S. 1637) (proposing to retain the acquisition of control requirement for I.R.C. section 269(a)(1), but to eliminate the common control exception for I.R.C. section 269(a)(2)). To date, these proposals have not been enacted, but the effective date of the proposals when enacted could be retroactive to February 13, 2003.

[196] The term "qualified stock purchase" generally refers to a taxable purchase of at least 80 percent of voting stock and 80 percent of all other stock (excluding vanilla preferred stock) of a corporation within a 12-month period. The date on which the requisite stock ownership tests are attained is the acquisition date (see §§ 7.5(c) and (d)).

[197] *See* Rev. Rul. 70-638, 1970-2 C.B. 71 (beneficiaries of a trust, which owns stock of corporation, indirectly control that corporation).

[198] *Younker Brothers, Inc. v. United States*, 318 F. Supp. 202 (S.D. Iowa 1970).

The scope of benefits that can be precluded by the application of I.R.C. section 269 is broad. Indeed, an "allowance" for the purposes of this section is considered to be anything that diminishes the tax liability of the taxpayer.[199] Nevertheless, I.R.C. section 269 will not apply, regardless of the taxpayer's intent, in three types of situations. The first is if the taxpayer could have obtained the same tax benefit in an alternative transaction. In such a case, the taxpayer has not obtained a benefit it would not otherwise enjoy.[200] The second is if the taxpayer could have obtained the same benefit, only proportionately smaller, if the taxpayer had obtained an amount of stock not constituting control of the acquired corporation.[201] The third is if the benefit is one Congress intended taxpayers to have. For example, the IRS has been unsuccessful in attempting to invoke I.R.C. section 269 to deny benefits conferred on S corporations or Western Hemisphere Trade Corporations.[202]

"Evasion or avoidance" is not defined in the code, but the regulations state that evasion or avoidance is not limited to cases involving criminal or civil penalties for fraud.[203]

For the IRS to use I.R.C. section 269, it must demonstrate that the "principal purpose" of the transaction was evasion or avoidance of tax. Because the "principal purpose" is a matter of fact, it has been the focal point of section 269 cases. Generally, the courts have been willing to accept transactions that involve substantial business reasons. Minor business reasons, although acceptable immediately after I.R.C. section 269 became effective, have been subsequently disallowed. Recently, the courts have accepted reasonable business purposes and have ruled that consideration of tax factors will not result in disallowance, unless a tax factor is the principal purpose.[204]

The following factors have been identified as those the IRS will consider in determining whether an acquisition has a valid business purpose:[205]

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[199] Treas. Reg. § 1.269-1(a).

[200] *Cromwell Corp. v. Commissioner,* 43 T.C. 313, 317 (1964), *acq.* 1965-2 C.B. 4.

[201] *Commodores Point Terminal Corp. v. Commissioner,* 11 T.C. 411, 417 (1948), *acq.* 1949-1 C.B. 1.

[202] *Modern Home Fire & Casualty Ins. Co. v. Commissioner,* 54 T.C. 839 (1970), *acq.* 1970-2 C.B. xx (S corporations); *A.P. Green Export Co. v. United States,* 151 Ct. Cl. 628 (1960) (Western Hemisphere Trade Corporations); Rev. Rul. 76-363, 1976-2 C.B. 90 (S corporations); Rev. Rul. 70-238, 1970-1 C.B. 61 (Western Hemisphere Trade Corporations). *See also Supreme Investment Corp. v. United States,* 468 F.2d 370 (1972); *Cherry v. United States,* 264 F.Supp. 969 (C.D. Cal. 1967); Field Service Advice 199926011 (Mar. 26, 1999).

[203] Treas. Reg. § 1.269-1(b).

[204] *See Stange Co. v. Commissioner,* 36 T.C.M. (CCH) 31 (1977); *VGS Corp. v. Commissioner,* 68 T.C. 563 (1977), *acq.* 1979-2 C.B. 2; *D'Arcy-MacManus & Masius, Inc. v. Commissioner,* 63 T.C. 440 (1975); *see also Fairfield Communities Land Co. v. Commissioner,* 47 T.C.M. (CCH) 1194 (1984) (motive for using I.R.C. section 269 was to obtain surplus cash held by the acquired corporation and not a desire to avoid taxes through the acquired corporation's net operating losses).

[205] *See,* Brown, Berkowitz, & Lynch, *supra* note 29.

- Whether the acquiring parties were aware of challenged tax benefits at the time of the acquisition and considered them;[206]
- Whether the acquired corporation is a mere shell;
- Whether acquisition of control or assets is necessary or useful to the acquirer's business;[207]
- How the relative value of the acquired tax benefit compares to the inherent economic profit of the enterprise;[208]
- Whether the tax benefit flows directly from the acquisition transaction;
- If the acquisition was by stock purchase instead of asset purchase, whether this method was the most feasible method of acquiring the business or assets of the acquired corporation;[209]
- If the assets were acquired in a tax-free transaction, whether this method was more feasible than a cash purchase.[210]

(ii) Partial Allowance

I.R.C. section 269(c) provides for (1) a partial allowance, (2) an allocation of gross income and disallowed deduction, credit, or allowance among the corporations or properties involved, or (3) a combination of (1) and (2), provided such allowance or allocation will not result in the evasion or avoidance of federal income tax where this was the purpose of the acquisition.

(iii) Use of I.R.C. Section 269

Most frequently, I.R.C. section 269 has been used to disallow the use of net operating loss carryovers to offset profits earned after a change in control. It also has been used, however, to disallow foreign tax credits, and investment credits; depreciation deductions and rental deductions; capital, ordinary, or section 1231 losses; earnings and profits deficits; returns; losses on sale of assets acquired with "built-in" losses; and other items.[211]

In a 1993 field service advice, the IRS discussed the application of section 269 to disallow the use of a merged corporation's net operating loss carryover.[212] Both a privately held company and a publicly held company operated a chain of supermarkets. The private company had enjoyed substantial taxable income for an extended time period and the public company had operating losses and emerged from chapter 11 with a net operating loss carryover. Under the plan, the private company would merge into the public company with the private

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[206] *Hawaiian Trust Co. v. United States*, 291 F.2d 761 (9th Cir. 1961); *John B. Stetson Co. v. Commissioner*, 23 T.C.M. (CCH) 876 (1964).
[207] *John B. Stetson Co.*, 23 T.C.M. (CCH) 876; *Superior Garment Co. v. Commissioner*, 24 T.C.M. (CCH) 1571 (1965).
[208] *R. P. Collins & Co.*, 303 F.2d 142 (1st Cir. 1962).
[209] *Baton Rouge Supply Co. v. Commissioner*, 36 T.C. 1 (1961), *acq.* 1961-2 C.B. 4.
[210] *D'Arcy-MacManus & Masius, Inc. v. Commissioner*, 63 T.C. 440 (1975).
[211] BITTKER & EUSTICE, *supra* note 23, at ¶ 14.41[2][b].
[212] Field Service Advice 1998-416 (July 9, 1993).

company's shareholders receiving the public company's stock for their shares. The public company would divest most of the private company's assets and devote its resources to the geographic areas where it operated.

The IRS concluded that I.R.C. section 269 applies when the principal purpose for an acquisition is the avoidance of federal income tax. In this case, the sale of the private company's historical business assets following the merger suggested that the purpose of the merger was to give the surviving company the use of the net operating loss carryover. However, because determining tax avoidance is purely a factual question, the IRS advised asserting I.R.C. section 269 against a taxpayer only if there is a strong case. Some factors that were presented in this case indicating that the merger was not for tax avoidance purposes were that the proxy statement indicated that the merger advanced the private company's general plan to gain control of a leading regional supermarket chain, and that the private company's board found that the merger would provide its shareholders a significant return and greater liquidity.

(iv) Avoiding Tax by Using Operating Losses

The regulations provide some examples of situations in which the IRS would consider it appropriate to use I.R.C. section 269 to prevent a corporation from using its net operating loss benefits. The IRS suggests that the following transactions will fall under I.R.C. section 269, unless there is evidence to the contrary:

- A corporation with large profits acquires control of a corporation with current, past, or prospective credits, deductions, net operating losses, or other allowances, and the acquisition is followed by other action as necessary to bring the deduction, credit, or other allowance into conjunction with income.[213]
- A person or persons with high-earning assets transfers them to a newly organized controlled corporation but retains assets producing net operating losses, which are used in an attempt to secure refunds.[214]
- A corporation acquires property, having in its hands an aggregate carryover basis materially greater than its aggregate fair market value at the time of such acquisition, and uses the property to create tax-reducing losses or deductions.[215]
- The regulations state that I.R.C. section 269 and related provisions can be applied to disallow net operating loss carryovers even though the loss is not disallowed under I.R.C. section 382. The following examples illustrate this position.[216]

213 Treas. Reg. §§ 1.269-3(b)(1), 1.269-6.
214 Treas. Reg. § 1.269-3(b)(3).
215 Treas. Reg. § 1.269-3(c)(1).
216 Treas. Reg. § 1.269-6.

Example 6.32

L Corporation has computed its taxable income on a calendar-year basis and has sustained heavy net operating losses for a number of years. Assume that A purchased all of the stock of L Corporation on December 31, 1995, for the principal purpose of using its net operating loss carryovers by changing its business to a profitable new business. Assume further that A made no attempt to revitalize the business of L Corporation during calendar year 1996 and that, during January 1997, the business was changed to an entirely new and profitable business. The carryovers will be disallowed under the provisions of I.R.C. section 269(a) without regard to the application of I.R.C. section 382.

Example 6.33

L Corporation has sustained heavy net operating losses for a number of years. In a merger under state law, P Corporation acquires all the assets of L Corporation for the principal purpose of using the net operating loss carryovers of L Corporation against the profits of P Corporation's business. As a result of the merger, the former stockholders of L Corporation own, immediately after the merger, 12 percent of the fair market value of the outstanding stock of P Corporation. If the merger qualifies as a reorganization to which I.R.C. section 381(a) applies, all net operating loss carryovers will be disallowed under the provisions of I.R.C. section 269(a) without regard to the application of I.R.C. section 382.

Example 6.34

L Corporation has been sustaining net operating losses for a number of years. P Corporation, a profitable corporation, acquired all the stock of L Corporation on December 31, 1995, for the purpose of continuing and improving the operation of L Corporation's business. During 1996, P Corporation transfers a profitable business to L Corporation for the principal purpose of using the profits of such business to absorb the net operating loss carryovers of L Corporation. The transfer is such as to cause the basis of the transferred assets in the hands of L Corporation to be determined by reference to their basis in the hands of P Corporation. L Corporation's net operating loss carryovers will be disallowed under the provisions of I.R.C. section 269(a) without regard to the application of I.R.C. section 382.[217]

(v) Ownership Changes in Bankruptcy

Treas. Reg. section 1.269-3(d) provides that, in the absence of strong evidence to the contrary, an ownership change in bankruptcy to which I.R.C. section 382(l)(5) applies will be considered to be made for tax avoidance purposes under I.R.C. section 269, unless the bankrupt corporation "carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 case. . . ." A temporary cessation of activities can be overcome (and the above standard met) if the corporation continues to use a "significant amount of the business assets or work force. . . ." The decision regarding "more than an insignificant amount of an active trade or business" is made without regard to continuity of business enterprise under Treas. Reg. section 1.368-1(d).

[217] Treas. Reg. § 1.269-6, Ex. 3.

§ 6.8 *LIBSON SHOPS* DOCTRINE

(a) Overview

Another factor to be considered is the extent to which the *Libson Shops*[218] doctrine applies to I.R.C. section 382. In *Libson Shops*, the Supreme Court introduced a tracing principle, requiring the company that used loss carryovers to be in "substantially the same business" as the company that incurred the loss. This tracing principle survives, in part, in the section 382 continuity of business enterprise requirement.

Before the enactment of current I.R.C. section 382 as part of the Tax Reform Act of 1986, there was some doubt about whether the *Libson Shops* doctrine might continue to apply in situations not covered by old section 382. The Tax Court held in *Clarksdale Rubber Co.*[219] that the taxpayer was not required to satisfy the *Libson Shops* doctrine, but the decision was based on the provision in I.R.C. section 382(a)(1)(C). The Ninth Circuit held in *Maxwell Hardware Co.*[220] that the *Libson Shops* doctrine did not apply to years covered by the 1954 Internal Revenue Code. The *Libson Shops* case is probably not applicable to I.R.C. sections 381 and 382. It would appear that these I.R.C. provisions superseded the disallowance of the restrictive provisions in *Libson Shops.* It can be argued that if *Libson Shops* continues to have any vitality, it should be restricted to tax attributes not specifically addressed in I.R.C. section 381 or other code sections. For example, the IRS in Rev. Rul. 80-144[221] stated that I.R.C. section 383 pre-empts the *Libson Shops* doctrine for the carryover of foreign tax credits.

The Conference Report accompanying the enactment of current section 382 clarifies, that current section 382 is intended to supplant the principles of *Libson Shops*, at least with regard to loss carryovers that are subject to limitation by section 382.[222] For loss carrybacks, however, at least one court has held that *Libson Shop* principles continue to apply.[223] Early efforts of the IRS to extend the *Libson Shops* doctrine to other tax attributes have given way to an acknowledgement by the IRS that later legislative action prevents such an extension.[224]

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[218] *Libson Shops v. Koehler*, 353 U.S. 382 (1957).
[219] *Clarksdale Rubber Co. v. Commissioner,* 45 T.C. 234 (1965).
[220] *Maxwell Hardware Co. v. Commissioner,* 343 F.2d 713 (9th Cir. 1965).
[221] 1980-1 C.B. 80.
[222] H. Rep. No. 841, 99th Cong., 2d Sess., at II-194 (1986).
[223] *National Tea Co. v. Commissioner*, 793 F.2d 864 (7th Cir. 1986).
[224] *See, e.g.*, Rev. Rul. 68-350, 1968-2 C.B. 159, *obsoleted by* Rev. Rul. 80-144, 1980-1 C.B. 80.

§ 6.9 CONSOLIDATED RETURN REGULATIONS

(a) Introduction

In addition to the general loss limitation rules discussed above, the use of losses by groups of corporations filing consolidated returns is subject to a number of special limitations. The provisions that address these limitations are extremely complex. The discussion here will be brief,[225] and will focus on four topics: (1) the consolidated net operating loss rules of Treas. Reg. section 1.1502-21[226] (and in particular the separate return year limitation (SRLY) rules of Treas. Reg. section 1.1502-21(c); (2) the consolidated section 382 rules of Treas. Reg. section 1.1502-90 through 99; (3) the Overlap Rule of Treas. Reg. section 1.1502-21(g); and (4) the rules governing disallowance of losses on the disposition of subsidiary stock of Treas. Reg. sections 1.337(d)-2T and 1.1502-35T.

(b) Consolidated Net Operating Loss Rules

Treas. Reg. section 1.1502-21(a) limits a consolidated group's ability to use loss carryovers and carrybacks to an amount equal to the group's consolidated net operating loss (CNOL)[227] deduction. The CNOL deduction is composed of (1) the group's CNOL carried from another consolidated return year and (2) any group member's NOL that arose in and is carried from a separate return year (SRY).

The second component of the CNOL deduction (i.e., a member's NOL carryover from a SRY) may be limited by Treas. Reg. section 1.1502-21(c) if the NOL carryover arose in and is carried from a separate return limitation year (SRLY). This limitation is called the SRLY limitation. Thus, the extent to which a consolidated group may include a loss in its CNOL deduction for a consolidated return year depends on whether the loss arose in a SRY with respect to the group and on whether that SRY is also a SRLY.

Treas. Reg. section 1.1502-1(e) provides that a SRY is a taxable year of a corporation for which the corporation files a separate return (that is, not as a member of a consolidated group) or for which it joins in the filing of a consolidated return by another group. Under Treas. Reg. section 1.1502-1(f), a SRY is generally treated as a SRLY. The regulations provide three exceptions to this general rule. The three exceptions are: (1) a SRY of the corporation that is the common

[225] For a more complete discussion of the use of net operating losses by consolidated groups, see Hennessey, Yates, Banks, and Pellervo, *The Consolidated Tax Return* (6th ed. 2002); and Dubroff, Blanchard, Broadbent, and Duvall, *Federal Income Taxation of Corporations Filing Consolidated Returns* (2d ed. 2002).

[226] Similar rules governing capital losses and built-in losses are set forth in Treas. Reg. §§ 1.1502-22 and 1.1502-15, respectively. Before 1997, the consolidated net operating loss rules were set forth in Treas. Reg. § 1.1502-21A. These rules also included a set of loss limitation rules—the consolidated return change of ownership rules (CRCO)—that generally no longer apply.

[227] A CNOL for any given year is generally the excess of the group's deductions over the group's gross income. Treas. Reg. § 1.1502-21(e).

parent for the consolidated return year to which the tax attribute is to be carried (the lonely parent rule);[228] (2) a SRY of any corporation that was a member of the group for each day of such year;[229] or (3) a SRY of a predecessor of any member if such predecessor was a member of the group for each day of such year.[230]

Generally speaking, the SRLY limitation allows the consolidated group to use a member's loss that arose in a SRLY only to the extent that the member with the loss contributed to the group's consolidated taxable income. For losses being absorbed in tax years beginning before January 1, 1997, the SRLY limitation was generally determined under Treas. Reg. section 1.1502-21A(c) (the "Old Regulations"). For losses being absorbed in tax years beginning on or after January 1, 1997, the SRLY limitation was generally determined under Treas. Reg. section 1.1502-21T(c) (the "Temporary Regulations"). For tax years having an unextended due date after June 25, 1999, current Treas. Reg. section 1.1502-21(c) applies to determine the SRLY limitation. The current regulations are substantially similar to the Temporary Regulations, apart from their introduction of the Overlap Rule, which will be discussed below.

Under the Old Regulations, the SRLY limitation for a particular year was determined solely by reference to the items generated in that year by the member carrying the loss. Thus, the SRLY limitation was determined on a year-by-year basis.

Under the current regulations, the SRLY limitation is generally determined based on the member's items of income, gain, deduction, and loss aggregated for the years the corporation is a member of the group (i.e., the "cumulative register").[231] Thus, a positive cumulative register for a member's contribution to consolidated taxable income allows the member's loss to be taken into account by the group. Conversely, a negative cumulative register for a member's contribution to consolidated taxable income prevents the member's loss from being taken into account by the group, even if the member had income for that year.

In certain cases, the SRLY limitation is based on the contribution made to a group's consolidated taxable income by several corporations rather than by solely the corporation with the loss carryover.[232] This occurs when the multiple corporations constitute a subgroup.[233] A subgroup for a loss carryback is generally composed of the corporation carrying back the loss (the loss member), and each other member of the group from which the loss is carried back that has been continuously affiliated with the loss member from the year to which the loss is carried through the year in which the loss arises.[234]

The importance of the SRLY limitation was reduced by the introduction in the current regulations of the Overlap Rule, which, as discussed in greater detail

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[228] Except in the case of a reverse acquisition or as provided in Treas. Reg. § 1.1502-75(d)(2)(ii). Treas. Reg. § 1.1502-1(f)(2)(i).

[229] Treas. Reg. § 1.1502-1(f)(2)(ii).

[230] Treas. Reg. § 1.1502-1(f)(2)(iii).

[231] Deductions and losses reduce the cumulative register only when such amounts are actually absorbed by the consolidated group. Treas. Reg. § 1.1502-21(c)(1)(i)(B).

[232] Treas. Reg. § 1.1502-21(c)(2).

[233] *Id.* There are anti-avoidance rules that prevent the inappropriate use of subgroups.

[234] Treas. Reg. § 1.1502-21(c)(2)(ii).

below, has the effect of eliminating the SRLY limitation in certain cases in which both SRLY and section 382 would otherwise apply.

(c) Application of I.R.C. Section 382 to Consolidated Groups

(i) Background

The consolidated return regulations often reflect a single-entity approach to the taxation of consolidated groups. Under this approach, members of a consolidated group are treated as divisions of a single corporation. One important example of single-entity treatment is the computation of consolidated taxable income, which generally permits losses earned by one member during the period of consolidation to offset income earned by another member during such time. On June 25, 1999, the IRS issued final regulations addressing the application of I.R.C. section 382 to consolidated and controlled groups.[235] Consistent with the approach adopted elsewhere in the consolidated return regulations, these regulations adopt a single-entity rule, and treat a consolidated group as one entity for applying I.R.C. section 382.[236]

The final regulations are generally effective for testing dates after June 25, 1999. Because of the highly technical nature of the regulations, an exhaustive analysis of their content is beyond the scope of this book. The discussion below first provides an overview of the final regulations. It then summarizes and illustrates (with a series of examples) three of the fundamental provisions of the regulations: the determination of whether a consolidated group is a loss group, the determination of whether a loss group has an ownership change, and the determination of the value of the loss group following an ownership change.

(ii) Overview

Treas. Reg. sections 1.1502-90 through -99 provide the tax treatment for net operating losses that arise in (and net unrealized built-in losses with respect to) years that are not SRLYs with respect to a consolidated group. In general, these rules adopt the single-entity approach to determine ownership changes and the section 382 limitation with respect to such losses.

Treas. Reg. sections 1.1502-94 and -95 apply to corporations that join or leave a consolidated group. Some of the rules depart from the single-entity approach, because the rules define the section 382 limitation for attributes that are not worthy of single-entity status (e.g., net operating losses of a member that arose before the member joined the consolidated group). Other rules address how the single-entity approach "unwinds" when one or more members of a consolidated group that is subject to a section 382 limitation leave the consolidated group. Section 1.1502-96 contains some miscellaneous operating rules. Most notable are the so-called "fold-in" rules, addressing transactions in which a consolidated group first acquires a loss corporation in a transaction in which the loss corpora-

[235] T.D. 8825, 64 Fed. Reg. 36175 (July 2, 1999); T.D. 8824, 64 Fed. Reg. 36116 (July 2, 1999).
[236] *See* Treas. Reg. §§ 1.1502-91 through -99.

tion has an ownership change, and in which the consolidated group subsequently has a change in ownership.

Treatment of the consolidated group as a single entity means that in determining whether the consolidated group is a "loss corporation," the losses of all members of the consolidated group are taken into account.[237] Thus, a consolidated group will be a loss group if any member has a net operating loss that is not a SRLY loss.[238]

Treatment of the consolidated group as a single entity also means that in determining whether a consolidated group has an ownership change, only shifts in ownership of the common parent are taken into account.[239] Thus, a loss group has an ownership change only if the loss group's common parent has an ownership change under I.R.C. section 382.

Finally, treatment of the consolidated group as a single entity means that the section 382 limitation is computed based upon the value of the stock of the common parent, not the separate group members.[240]

EXAMPLE 6.35

P, a holding company and the common parent of a consolidated group, files a consolidated tax return with its two subsidiaries, X and Y. P owns 90 percent of the stock of X and 100 percent of the stock of Y. X has a net operating loss in year 1 that is not a SRLY (e.g., the loss arose while P, X, and Y were members of the P consolidated group). The P group has no other losses. During year 1, A, an individual, sells 51 percent of the stock of P to B, an unrelated buyer, for $51.

Under the single-entity approach to section 382, the P/X/Y consolidated group is a loss group during year 1, because the losses of X (and of every other group member) are taken into account in determining whether the group is a loss group. Also, an ownership change occurs for the P/X/Y loss group. This is true even though on a separate-entity basis there is no ownership change at the X level (51 percent × 90 percent = 45.9 percent). Conversely, if A sold only 45 percent of the stock of P to B, and P sold 20 percent of the stock of Y to C, the group would continue and there would be no ownership change with respect to P, X, or Y. Because changes are determined only at the loss group parent level (P), the fact that Y (on a separate-entity basis) had an ownership change (45 percent × 80 percent + 20 percent = 56 percent) is immaterial.

Finally, the value of the P consolidated group should be $100, which is the value of the stock of P immediately before the ownership change.

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[237] Treas. Reg. § 1.1502-91(c)(1).

[238] In certain circumstances, a SRLY loss also may cause a consolidated group to be treated as a loss group. *See* Treas. Reg. § 1.1502-96.

[239] Under an anti-abuse provision, shifts in ownership of members of the consolidated group also are taken into account in a narrow set of circumstances. *See* Treas. Reg. § 1.1502-92(c).

[240] Treas. Reg. § 1.1502-91(a). The value of the stock of the common parent is the value, immediately before the ownership change, of the stock of each member, other than stock that is owned directly or indirectly by another member. Treas. Reg. § 1.1502-93. Net unrealized built-in gain (NUBIG), and other adjustments to the value limitation also are made on a single-entity basis. *See* Treas. Reg. § 1.1502-93 and -95.

EXAMPLE 6.36 BUYING A LOSS CORPORATION AND CAUSING AN OWNERSHIP CHANGE: SEPARATE-ENTITY COMPUTATION

A, an individual, owns 100 percent of the stock of P. P has two wholly owned subsidiaries, S and L. P purchased all of the stock of L (a loss corporation). L had an ownership change when it joined the P/S consolidated group.[241] The amount of the consolidated taxable income for a post-change year that may be offset by L's pre-change losses cannot exceed L's separately computed section 382 limitation.[242]

EXAMPLE 6.37 BUYING A LOSS CORPORATION AND CAUSING AN OWNERSHIP CHANGE: SUBSEQUENT CHANGE AT THE PARENT LEVEL

M corporation owns 100 percent of the stock of P, and P owns 100 percent of the stock of L. P purchased all the stock of L (a loss corporation) for $1,000 on January 1, 2002, a time when the long-term tax-exempt bond rate was 8 percent. Thus, the section 382 limitation with respect to L's losses for 2002 was $80. On January 1, 2003, when the rate was 10 percent, M acquired all of the stock of L for $1,500. At that time, L's value was only $600. The section 382 limitation on L's SRLY losses (e.g., losses that arose before L joined the P group) remains at $80 and is not reduced to $60 ($600 × 10 percent). P's overall loss limitation for the P/L group is $150. The use of L's losses will simultaneously reduce both the L limitation and the P group limitation.[243]

EXAMPLE 6.38 EFFECTS OF SUBSIDIARY'S LEAVING THE CONSOLIDATED GROUP AS A RESULT OF AN OWNERSHIP CHANGE

1. Unabsorbed losses on leaving the group: P and its subsidiary, L, have filed a consolidated return since L's inception. L has losses that were not absorbed by the group. P sells all of the stock of L. L's losses are subject to the I.R.C. section 382 rules in the hands of the purchaser, but P is unaffected.

2. Prior consolidated NOL subject to I.R.C. section 382: four years ago M acquired all of the P stock (and with it, P's subsidiary L). At the time of the acquisition of P, the P/L group had a consolidated NOL, which became subject to a section 382 limitation. P now sells all of L. Any loss that is limited by the previous change (i.e., subject to a consolidated section 382 limitation) continues to be so limited with respect to L's leaving the group.[244] L's section 382 limitation with respect to such loss is zero, unless M (the common parent)

[241] L is a "new loss member" of the P group. Treas. Reg. § 1.1502-94(a)(1).

[242] Treas. Reg. § 1.1502-94(b)(1).

[243] Treas. Reg. §§ 1.1502-94(a)(3), 1.1502-96(c). *See also Tax Analysts Highlights & Documents*, LEXIS, 91 TNT 57-48 (Mar. 13, 1991) (letter from Mark Silverman and Kevin Keyes confirming results of a conference with IRS officials).

[244] In addition to losses generated in the M/P/L group, a SRLY loss that L brought into the group that (1) was subject to an ownership change within six months before, on, or after L entering the group, or (2) ages for five years in the P group without an ownership change, is treated as a consolidated NOL. Treas. Reg. § 1.1502-96(a).

apportions all or part of the consolidated section 382 limitation to L.[245] Any amount of the section 382 limitation apportioned to L reduces the limitation remaining for P.

EXAMPLE 6.39 JOINING THE CONSOLIDATED GROUP WITH NO OWNERSHIP CHANGE; SEPARATE ENTITY COMPUTATION

P, which has owned 50 percent of L for more than three years, purchases 30 percent of the L stock from C, the other 50 percent shareholder, on June 1, 2002. P has a single shareholder, A. As a result, L joins the P consolidated group but there is no ownership change under I.R.C. section 382. The L losses are SRLY losses. On January 1, 2004, a sells 40 percent of P stock to B. On January 1, 2005, C sells the remaining 20 percent of L stock to D. I.R.C. section 382 is applied to L on a separate entity basis. Thus, there is a 52 percent ownership shift (within three years) and L undergoes an ownership change.[246] The section 382 limitation is computed solely by reference to the value of L. (This example presumes that the overlap rule, discussed below, does not apply).

EXAMPLE 6.40 LEAVING A CONSOLIDATED GROUP AND CAUSING AN OWNERSHIP CHANGE

The day when L leaves the consolidated group is a testing date for determining whether L, on a separate-entity basis, has an ownership change.[247] Thus, changes at the M or P level in the previous three-year period will determine whether L has an ownership change. Assume that M owns all of the stock of P, and P owns all of the stock of L. On January 1, 2002, the shareholders of M sell 15 percent of their stock to A. On January 1, 2003, M sells 20 percent of its P stock to B. On January 1, 2004, P sells 30 percent of its L stock to C. Within the three-year period ending on January 1, 2004 (the date L is deconsolidated), there has been a 52.4 percent ownership change,[248] treating L on a single-entity basis. If any part of the consolidated NOL is apportioned to L as it leaves the group, P must also apportion some or all of the consolidated section 382 limitation to L; otherwise, L's section 382 limitation will be zero, and L will not be able to use any amount of consolidated NOL apportioned to it.[249]

(d) Overlap Rule

The 1999 regulations also introduced the Overlap Rule for built-in losses, net operating losses, and capital losses. If the Overlap Rule applies, it eliminates the

[245] The apportionment consists of two elements: (1) the value element, related to the value of the loss group multiplied by the long-term tax-exempt bond rate, without regard to any adjustments for short years, unused limitations, or built-in gains; and (2) the adjustment element, relating to unused limitations or built-in gains for the taxable year in which the member leaves the group. Treas. Reg. § 1.1502-95(c)(1).

[246] Before: A, 50 percent; C, 50 percent. After: A, 48 percent (60% × 80%); B, 32 percent (40% × 80%); C, 0 percent; D, 20 percent. B and D have increased their ownership by 52 percent.

[247] Treas. Reg. § 1.1502-95(b)(1)(iii).

[248] New shareholders on January 1, 2004, are: A, 8.4 percent (15% × 80% × 70%); B, 14 percent (20% × 70%); and C, 30 percent, for a total of 52.4 percent.

[249] P also may apportion some or all of a NUBIG to L when it leaves the group, such that L's recognition of a NUBIG also would increase L's section 382 limitation after L leaves the group. Treas. Reg. § 1.1502-95(c)(2)(ii).

SRLY limitation.[250] If the Overlap Rule requirements are not satisfied, the loss remains subject to a SRLY limitation and a Section 382 limitation. The Overlap Rule does not apply to carrybacks and does not apply to credits.

The Overlap Rule generally applies and eliminates the SRLY limitation with respect to a corporation's losses if the corporation with a SRLY becomes a member of a consolidated group within six months of (i.e., either before or after) having an ownership change that gives rise to a Section 382 limitation.[251]

If the Overlap Rule applies, the SRLY limitation does not apply, but for purposes of future ownership changes, attributes continue to be treated as having arisen in a SRLY.

EXAMPLE 6.41

On January 1, 1999, P, the common parent of a calendar-year consolidated group, purchases all the stock of S from an unrelated party for $50 million. S has a net operating loss (NOL) of $5 million. P's acquisition of all the stock of S results in a section 382 ownership change that gives rise to a section 382 limitation. The section 382 limitation for S computed under section 382(b)(1) is $50 million times the applicable federal long-term tax-exempt rate. P's acquisition of S also results in S becoming a member of the P group. As a result, the overlap rule applies so that S's NOL is not subject to a SRLY limitation in the P group.

The Overlap Rule also applies to situations in which multiple corporations join the consolidated group. In those situations, however, the Overlap Rule will only apply if the section 382 subgroup and the SRLY subgroup are identical in membership. This additional requirement is designed to ensure that the losses that are no longer subject to the SRLY limitation remain subject to a comparable limitation, based on the same corporations. In most situations the membership of the two subgroups will be identical, but in limited situations the two will differ.[252] If the membership is not identical, both the SRLY limitation and the Section 382 limitation apply to the losses.

EXAMPLE 6.42

On January 1, 1999, P, the common parent of a calendar-year consolidated group, purchases all the stock of S from an unrelated party. S was the common parent of another group with two wholly owned subsidiaries, S1 and S2. S1 has a NOL that was not subject to a SRLY limitation in the S group. S, S1, and S2 satisfy the definitions of both a SRLY

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[250] Treas. Reg. § 1.1502-21(g). For a detailed discussion of the 1999 regulations, including the Overlap Rule, *see* Yates, Eisenberg, Madden, Rainey, and Vogel, Final SRLY/Consolidated Section 382 Regs. Remove SRLY Limitation for Most Groups As of 1999, 91 *J. Tax'n* 325 (Dec. 1999).

[251] The Overlap Rule is generally effective for tax returns having an unextended due date after June 25, 1999. Treas. Reg. § 1.1502-21(h).

[252] One reason why the subgroup membership may differ is that the Section 382 subgroup requires that the corporations bear an I.R.C. section 1504 relationship, while the SRLY subgroup does not contain a similar requirement.

subgroup and a section 382 subgroup in the P group. They were all members of the S group and joined the P group together, and S1's NOL was not subject to a SRLY limitation in the S group. In addition, they satisfy the section 382 subgroup condition because they bear a section 1504 subgroup relationship to one another, with S as the subgroup parent. The SRLY subgroup and the section 382 NOL subgroup are therefore coextensive. P's acquisition of all the stock of S results in a section 382 ownership change of the subgroup that gives rise to a section 382 limitation. S, S1, and S2 also become members of the P group as a result of P's acquisition of S. The overlap rule applies.[253]

(e) Disallowance of Losses on the Disposition of Subsidiary Stock

Two other sets of rules (Treas. Reg. section 1.337(d)-2T and Treas. Reg. section 1.1502-35T) limit a consolidated group's ability to take into account a loss sustained on the disposition of subsidiary stock. A disposition for this purpose includes a worthless stock deduction. The purpose of these rules is to prevent taxpayers from using the consolidated return rules (including the basis adjustment rules) to circumvent the 1986 repeal of the *General Utilities*[254] doctrine.

(i) Treas. Reg. Section 1.337(d)-2T Loss Disallowance

On March 7, 2002, the Treasury Department and the IRS issued temporary and proposed regulations (T.D. 8984)[255] concerning the loss disallowance rules. These regulations respond to the Federal Circuit Court of Appeal's invalidation of the duplicated-loss factor of Treas. Reg. section 1.1502-20 of the Treasury Regulations on the grounds that it exceeded the scope of the authority delegated by Congress under I.R.C. section 1502.[256]

Prior to the issuance of the regulations in T.D. 8984, a consolidated group's ability to take a loss into account on the disposition of the stock of a subsidiary was determined under Treas. Reg. section 1.1502-20. Treas. Reg. section 1.1502-20(a)(1) generally disallowed a deduction for any loss recognized by a member of a consolidated group with respect to the disposition of the stock of a subsidiary. Treas. Reg. section 1.1502-20(c), however, limited the application of Treas. Reg. section 1.1502-20(a)(1) and allowed a loss to the extent the loss exceeded the sum of three factors: extraordinary gain dispositions, positive investment adjustments, and duplicated losses. If Treas. Reg. section 1.1502-20 resulted in the disallowance of loss and the subsidiary that had stock disposed of had net operating loss or capital loss carryovers, the common parent of the consolidated group could elect under Treas. Reg. section 1.1502-20(g) to reattribute the subsidiary's losses (and any section 382 limitation associated with the losses) to itself, to the extent of any disallowed stock loss on the disposition.

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[253] *See* Treas. Reg. § 1.1502-21(g)(5), Ex. 5.

[254] *See General Utilities & Operating Co. v. Helvering,* 296 U.S. 200 (1935).

[255] T.D. 8984, 67 Fed. Reg. 11034 (Mar. 12, 2002).

[256] *See Rite Aid Corp. v. United States,* 255 F.3d 1357 (Fed. Cir. 2001). For a more detailed analysis of T.D. 8984, see Vogel and Hering, New Loss Disallowance Regulations–Welcome to the Age of Tracing and Appraisals, 96 *J. Tax'n* 327 (June 2002).

Treas. Reg. section 1.1502-20 also applied to reduce the basis in stock of a subsidiary immediately before the subsidiary ceased to be a member of any consolidated group. The regulations generally required a reduction in stock basis (but not below fair market value) to reflect the sum of the Treas. Reg. section 1.1502-20(c) factors (i.e., extraordinary gain dispositions, positive investment adjustments, and duplicated losses).

Following the issuance of T.D. 8984, a consolidated group's ability to take a loss into account on the disposition of the stock of a subsidiary is determined under Treas. Reg. section 1.337(d)-2T. Treas. Reg. section 1.337(d)-2T provides loss limitation rules using a tracing and appraisal regime. Under these rules, a loss on the disposition of the stock of a subsidiary is disallowed to the extent that loss is attributable to the recognition of built-in gain on the subsidiary's disposition of an asset. Treas. Reg. section 1.337(d)-2T also applies to reduce the basis in stock of a subsidiary (but not below fair market value) for recognized built-in gains, immediately before the subsidiary ceases to be a member of any consolidated group.

For purposes of Treas. Reg. section 1.337(d)-2T, a disposition is any event in which gain or loss is recognized. An asset's built-in gain is generally the amount by which the value of the asset exceeded its basis at the time the subsidiary owning the asset became a member of the consolidated group.

The application of Treas. Reg. section 1.337(d)-2T is illustrated in Example 6.43.

EXAMPLE 6.43

P bought all the stock of T for $100 on February 1, 2000, and T became a member of the P consolidated group. P's basis in the stock of T was $100. T had two assets each with a value of $50 and basis of $0. T sold one asset in 2001 and recognized $50 of built-in gain on the sale. P's basis in the T stock increased from $100 to $150 as a result of the gain from the sale. P sells all the stock of T on December 31, 2002, for $100 and recognizes a loss of $50. Because the entire loss is attributable to the recognition of gain that was built-in at the time P acquired T, no deduction is allowed to P for the $50 loss.

Treas. Reg. section 1.337(d)-2T generally applies to dispositions and deconsolidations after March 6, 2002. Treas. Reg. section 1.337(d)-2T applies to all dispositions after March 6, 2002, regardless of when the subsidiary was acquired.

The current regulations require taxpayers to attach a statement to their tax returns identifying the amount of allowed loss.[257] Failure to attach this statement can result in the disallowance of the loss, although the IRS has granted section 9100 relief in some such cases.

For dispositions occurring prior to March 7, 2002 (or for dispositions occurring after March 6, 2002, pursuant to a binding written contract entered into prior to March 7, 2002), consolidated groups may determine the amount of a member's allowable loss or basis reduction under Treas. Reg. section 1.1502-20 in its entirety. Alternatively, consolidated groups may irrevocably elect to recalculate the amount of disallowed loss from a prior disposition of the stock of a

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[257] Treas. Reg. §§ 1.337(d)-2T(c)(1) and (c)(3).

subsidiary. According to Treas. Reg. section 1.1502-20T(i), consolidated groups may recalculate their disallowed loss on the disposition of the stock of a subsidiary under either Treas. Reg. section 1.1502-20(c) (taking into account only the sum of extraordinary gain dispositions and positive investment adjustments) (referred to as "1.1502-20 lite"), or Treas. Reg. section 1.337(d)-2T. If the amount of disallowed loss is reduced as a result of Treas. Reg. section 1.1502-20T(i), the consolidated group may also have to reduce the amount of any losses that were reattributed to the common parent under Treas. Reg. section 1.1502-20(g). If a reattributed loss is reduced, the losses of the disposed-of subsidiary are correspondingly increased.

An election under Treas. Reg. section 1.1502-20T(i) generally is made with the original return for the tax year that includes March 7, 2002. Certain additional rules apply if the amount of reattributed losses is reduced under Treas. Reg. section 1.1502-20T(i):

1. A rule requiring a selling consolidated group that reattributed a portion of a subsidiary's loss under Treas. Reg. section 1.1502-20(g) to notify the subsidiary (and any consolidated group that acquired it) of any reduction in the amount of reattributed loss.
2. A rule permitting a selling consolidated group to reduce the amount, if any, of the section 382 limitation attributed to the common parent as part of a Treas. Reg. section 1.1502-20(g) reattribution election and correspondingly to increase the amount of the section 382 limitation available to the disposed of subsidiary.
3. A rule permitting a consolidated group that acquired a subsidiary whose net operating loss is increased as a result of Treas. Reg. section 1.1502-20T(i) to make an election under Treas. Reg. section 1.1502-32T(b)(4) to waive the loss in order to avoid basis reductions in the subsidiary's stock under Treas. Reg. section 1.1502-32.

Consolidated groups that had pre-March 7, 2002, subsidiary stock losses disallowed by reason of Treas. Reg. section 1.1502-20 will want to consider the various options available to them under Treas. Reg. section 1.1502-20T(i). Factors to consider include:

- In applying Treas. Reg. section 1.337(d)-2T retroactively, the availability of fair market value data for the subsidiary's assets when it was acquired by the consolidated group and the ability to trace stock basis adjustments for the subsidiary to gain recognition on dispositions of those assets;
- Whether availability of a reattribution election under Treas. Reg. section 1.1502-20(g) (whether Treas. Reg. section 1.1502-20 is applied with or without the loss duplication factor) produces a better result than applying the tracing and appraisal regime (e.g., because an allowed stock loss would be capital but the reattributed losses are ordinary in character); and

- Who benefits, the selling consolidated group or the purchaser of the subsidiary, if a reattributed loss is reduced and correspondingly increases the subsidiary's loss carryovers.

(ii) Treas. Reg. Section 1.1502-35T Transfers of Subsidiary Member Stock and Deconsolidations of Subsidiary Members

On the same day the new loss disallowance regulations were issued, the IRS announced, in Notice 2002-18, [258] forthcoming additional regulations to govern certain dispositions of stock (or another asset that reflects the basis of stock), occurring after March 6, 2002.

The reason given for these additional regulations was that:

> The IRS and Treasury believe that a consolidated group should not be able to benefit more than once from one economic loss. Accordingly, the IRS and Treasury intend to issue regulations that will prevent a consolidated group from obtaining a tax benefit from both the utilization of a loss from the disposition of stock (or another asset that reflects the basis of stock) and the utilization of a loss or deduction with respect to another asset that reflects the same economic loss.

On March 11, 2003, the Treasury Department and the IRS issued (in temporary form) the regulations (T.D. 9048)[259] forecast by Notice 2002-18. These regulations police loss duplication through a basis redetermination regime and a loss suspension regime. In addition to basis redetermination and loss suspension, these regulations also affect worthless stock deductions in situations in which a worthless stock deduction is taken with respect to a subsidiary. The regulations require the CNOL carryforward to be reduced to the extent the member whose stock has been treated as worthless contributed to the CNOL.[260]

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[258] Notice 2002-18, 2002-1 C.B. 644.

[259] T.D. 9048, 68 Fed. Reg. 12287 (Mar. 14, 2003).

[260] For a more detailed analysis of T.D. 9048, *see* Yates, Vogel, Hering, and Hoffenberg, The Final Factor–Temp. Reg. 1.1502-35T Takes a New Approach to Barring Duplicated Loss, 98 *J. Tax'n* 263 (May 2003).

CHAPTER SEVEN

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§ 7.1 INTRODUCTION

The objective of this chapter is to consider some of the miscellaneous tax topics not covered in the previous six chapters. Included here is a discussion of the impact of debt forgiveness on the earnings and profits account, limitations on the use of I.R.C. section 351, corporate liquidation, application of I.R.C. section 338, exemption of bankruptcy or insolvency proceedings from personal holding company tax, impact of the establishment of a bankruptcy estate on S corporation status, and some problems encountered in determining whether an issue is debt or stock under I.R.C. section 385. This chapter also addresses a number of administrative issues not covered elsewhere.

§ 7.2 EARNINGS AND PROFITS

(a) Introduction

The earnings and profits of a corporation determine the extent to which corporate distributions are taxable at dividend rates.[1] Earnings and profits must also be considered in determining the personal holding company tax and the accumulated earnings tax. There are two factors to be considered in analyzing the impact of bankruptcy proceedings on the earnings and profits account of a corporation. The first deals with the need to adjust the earnings and profits account by the amount that the canceled indebtedness exceeds the reduction in the basis of the assets. The second concerns the carryover of the earnings and profits balance—which is frequently a deficit—to the reorganized corporation.

(b) Account Adjustment

Prior to the passage of the Bankruptcy Tax Act of 1980, the procedures to follow in accounting for the impact of debt discharge on the earnings and profits of a corporation were unclear. The Bankruptcy Tax Act did clarify the procedures to follow in adjusting the account, but it failed to clarify the time period in which the adjustment should be made.

(i) Prior Law

Generally, the determination of the earnings and profits of a corporation for dividend purposes is based on generally accepted accounting principles that take into consideration economic realities of the transaction as well as the tax impact of a given transaction. Thus, nontaxable income items, such as interest on state and municipal bonds, increase the earnings and profits available for dividends. Similarly, losses and expenses disallowed for tax purposes reduce the earnings and profits.

[1] Since the enactment of I.R.C. section 1(h)(11) in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (May 28, 2003), the dividend rate and the capital gains rate have generally been equal. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 752, 760, 108th Cong., 1st Sess. (2003).

Prior to the Bankruptcy Tax Act of 1980, the courts and the IRS considered the effect of debt cancellation on earnings and profit. The Tax Court, in *Meyer v. Commissioner*,[2] reasoned that, to the extent there is a reduction in basis, there is a deferral of profit until the assets are sold. At that time the gain will be realized and the earnings and profits will be increased by the amount of the gain. Earnings and profits, however, would never be increased by the amount that the cancellation of indebtedness exceeded the basis adjustment. Therefore, the Tax Court held that the earnings and profits should be increased by the excess.

The Eighth Circuit reversed the Tax Court decision and held that because section 395 of the Bankruptcy Act and Treas. Reg. section 1.61-12(b) provide that no income is realized on debt cancellation in Chapter XI proceedings, these sections preclude any adjustment to the earnings and profits account.

The IRS announced in Rev. Rul. 75-515[3] that it would not follow the decision in *Meyer* in Chapter XI proceedings, and that the deficit in earnings and profits would be reduced by the amount that the cancelled debt exceeds the reduction of the basis in retained assets. Thus, there was no question regarding the nature of the adjustment to earnings and profits in prior-law Chapter XI proceedings as far as the IRS was concerned. If the earnings and profits account survives a prior-law Chapter X reorganization, it would appear that the provisions that applied to Chapter XI would also have applied to Chapter X.

In an out-of-court settlement under prior law, the debt forgiveness was considered taxable income only to the extent that the debtor was solvent after the cancellation. The taxpayer could have elected to reduce the basis by the amount subject to tax and not report the gain in gross income. The net effect was that earnings and profits, either now or at some future date, would have been increased due to the gain from debt cancellation to the extent the debtor was solvent. One question that remained unanswered under prior law was whether the earnings and profits were to be reduced by the amount of the debt forgiveness that was not subject to tax because of the debtor's insolvency.

Treas. Reg. section 1.312-6(b) provides that among the items entering into the computation of corporate earnings and profits are income exempted by statute, income not taxable by the federal government under the Constitution, and items includible in gross income. This regulation, along with Rev. Rul. 75-515, provided evidence that an adjustment to earnings and profits was necessary when a gain on debt cancellation was not subject to tax. Although Rev. Rul. 75-515 dealt with bankruptcy proceedings, its application to out-of-court settlements was not necessarily precluded.

(ii) Bankruptcy Tax Act

I.R.C. section 312(*l*) provides two situations in which adjustments must be made to the earnings and profits account: when income is earned due to debt discharge and when stockholder interest is terminated as a result of a reorganization.

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[2] 46 T.C. 65 (1966), *rev'd,* 383 F.2d 883 (8th Cir. 1967).

[3] 1975-2 C.B. 117.

(iii) Discharge of Indebtedness Income

I.R.C. section 312(*l*)(1) provides that the earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under I.R.C. section 1017. The implication is that excluded income from debt discharge under I.R.C. section 108 not used to reduce basis increases the earnings and profits of the corporation or reduces a deficit. Thus, the provision codifies the position the IRS took in Rev. Rul. 75-515.[4]

The year in which the adjustment is made may depend on the elections made by the debtor. For example, if the debtor elects first to reduce depreciable property, there is some question as to when to make the adjustment. The adjustments to basis are made at the beginning of the debtor's first tax year immediately following the debt discharge. Thus, the amount of debt discharge income not available to reduce basis is not known until the next year. It has been argued that in such cases the adjustment should be made in the first tax year following discharge.[5] However, if the income from debt discharge reduces the tax attributes, the earnings and profits would be reduced in the year of discharge[6].

(iv) Reduction of Deficit When Shareholders' Interest Is Terminated

I.R.C. section 312(*l*)(2) provides that a deficit in earnings and profits is to be reduced if the interest of any shareholder is terminated or extinguished in a title 11 or similar tax-free corporate reorganization under I.R.C. section 368(a)(3)(A). Note that for the reduction to take place there must be a deficit and the reduction is limited to the extent of the deficit. Also, the reduction may not exceed the paid-in capital allocated to the interest of the shareholder, which is terminated or extinguished.

The idea that the termination of the shareholder's interest should be accompanied by the elimination of any deficit in the earnings and profits account attributable to the terminated interest seems to have a logical basis. However, at least one commentator suggests that it is not consistent with the concepts presented elsewhere, that the creditors generally should succeed to the interest formerly held by shareholders.[7]

[4] *See also* Field Service Advice 1999-540 (undated), 1999 TNT 15-83 (Jan. 25, 1999). The IRS concluded that income from debt discharge increases earnings and profits to the extent it is not used to reduce the basis of assets under I.R.C. section 1017. The IRS also concluded that the increase in earnings and profits resulting from debt discharge creates current earnings and profits for purposes of determining whether a distribution during the year of the debt discharge is a dividend, and does not merely reduce a deficit in accumulated earnings and profits.

[5] Eustice, Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals—Corporate Aspects, 36 *Tax L. Rev.* 1, 42 (1980).

[6] *Id.*

[7] Watts, Corporate Acquisitions and Divisions Under the Bankruptcy Tax Act: The New "G" Type Reorganization, 59 *Taxes* 845, 854 (1981).

One problem encountered in applying this provision is in determining the amount of paid-in capital. The code does not define paid-in capital. Paid-in capital is (or was) referred to in several code and regulation sections:[8]

- I.R.C. section 382(c) (before amendment by the Tax Reform Act of 1986) used the term in one of several tests to identify stock not taken into account for purposes of the section's reduction in tax attributes.
- I.R.C. sections 815(e)(1) and 819(b)(2) (before amendment by the Tax Reform Act of 1984) referred to paid-in capital in allocating life insurance company distributions pursuant to certain plans of mutualization.
- Treas. Reg. section 1.565-3(a) refers to paid-in-capital in describing the effect of consent dividends.
- Treas. Reg. sections 1.857-7(b) and 1.1377-2(a) illustrate distributions that are chargeable to capital rather than to accumulated earnings.
- Treas. Reg. section 1.964-1(e)(3) measures retained earnings for any year in part by reference to adjusted paid-in capital, but provides no definition.
- Treas. Reg. section 20.2032-1(d)(4) refers to paid-in capital in illustrating unusual distributions of earnings to be taken into account for purposes of alternate valuations under the estate tax.

These references, however, provide little guidance.

Even though the term *paid-in capital* as used in this section relates more to a legal concept, its meaning should arguably be based on tax concepts, because the account being reduced—earnings and profits—has special tax meaning. The paid-in capital value as determined for corporate reporting purposes may be substantially different from the value used for tax purposes. For example, property contributed to form a corporation may be reported at market value at the time it is transferred to the corporation for corporate reporting purposes, but for tax purposes the basis in the property must generally be used. Another example is a stock dividend that increases the paid-in capital for corporate reporting purposes but has no effect for tax purposes.

Under the tax concept, it has been suggested that the amount of the paid-in capital probably should be determined by reference to the tax basis to the shareholder as of the original issuance of the stock, adjusted only to reflect transactions between the corporation and the shareholder that are recognized for tax purposes.[9] In other words, the amount should be computed disregarding any changes in the basis of the stock resulting from transactions with third parties, such as purchases of outstanding stock, or resulting from transactions not involving the corporation, such as the new market value basis acquired at death under I.R.C. section 1014.[10]

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[8] *Id.*

[9] *Id.*

[10] In the consolidated return context, *see, e.g.,* Treas. Reg. section 1.1502-32T for basis consequences that might result from a debtor-member's exclusion of DOI income.

(c) Earnings and Profit Carryover

Prior to the introduction of I.R.C. section 381, the extent to which the earnings and profits account was carried over from a target corporation to an acquiring corporation following a bankruptcy settlement or reorganization was not clear. The important cases that deal with the subject all relate to the 1939 code. The decisions were based on the old law, which did not contain the provisions now found in I.R.C. section 381.

Current section 381 provides that in the case of a tax-free reorganization (including a section 368(a)(1)(G) reorganization), the earnings and profits or deficit will carry over. However, deficits of one corporation cannot be used to reduce the amount of pre-reorganization earnings brought by any other corporation to the combination; they may only be used to offset future earnings. Again, these provisions would apply to chapter 11 and out-of-court proceedings.

§ 7.3 INCORPORATION

(a) Introduction

In general, I.R.C. section 351 provides that no gain or loss will be recognized if *property* is exchanged solely for stock[11] of a controlled corporation. I.R.C. section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and, immediately after the exchange, such person or persons are in control (as defined in I.R.C. section 368(c)) of such corporation. I.R.C. section 351(b) provides that if in addition to stock of the transferee, other property or money is received in exchange for property (i.e., "boot"), the transferor is required to recognize gain (not in excess of the amount of money received, plus the fair market value of other property), but not loss. I.R.C. section 357(a) provides generally that the transferee corporation's assumption of a liability is not treated as money or other property for purposes of I.R.C. section 351(b). I.R.C. section 357(c), however, requires a transferor in a section 351 exchange to recognize gain if the sum of the amount of the liabilities assumed by the transferee exceeds the adjusted basis of the property the transferor transfers to the transferee. Transactions are often structured to avoid this outcome and thus, the incorporation of property ordinarily qualifies as a tax-free transaction under I.R.C. section 351(a), even though the transferee corporation assumes liabilities in the exchange.[12]

[11] Prior to 1989, I.R.C. section 351 could apply if a transferor received "stock or securities" in exchange for property. Removal of "securities" from this provision should not be confused with the discussion below under the heading I.R.C. Section 351(d), in which the securities under consideration are securities owned by a transferor that are being transferred (as property) in exchange for a transferee's stock.

[12] I.R.C. section 357(d) provides that, for purposes of I.R.C. section 357(a), a recourse liability (or portion thereof) shall be treated as assumed by a transferee corporation if the transferee corporation has agreed to, and is expected to satisfy, such liability (or portion), and a non-recourse liability shall be treated as assumed by the transferee corporation acquiring assets subject to such non-recourse liability (subject to certain exceptions).

As defined in I.R.C. section 368(c), "control" means stock constituting 80 percent of the aggregate voting power and 80 percent of the number of shares of each class of nonvoting stock.[13] In determining "control," all classes of voting stock are aggregated.

Note that at the outset of this description of section 351 transactions, the word *property* is italicized. In general, *property* includes the usual categories of tangible property as well as contract rights, leasehold interests, goodwill, employment contracts, patents, know-how, and so forth. If, however, the transferor's "property" was a receivable owed to it by the transferee corporation, then an exchange of that receivable for stock of the transferee corporation could result in the recognition of gain or loss. Under prior law, the indebtedness of the transferee corporation that was not evidenced by a security was considered property.[14] Also, a claim for accrued interest on the indebtedness of the transferee corporation was transferred property.[15]

(b) I.R.C. Section 351(d)

I.R.C. section 351(d), as amended by the Bankruptcy Tax Act of 1980, eliminated this nonrecognition provision by providing that stock issued for services, indebtedness of the transferee corporation, and interest on this indebtedness is not considered stock issued in return for property.

The net effect of this change is twofold:

1. Creditors may be required to recognize a gain or loss on an exchange of nonsecurity debt for stock, where previously this would have been avoided.
2. Acquisition of stock by nonsecurity creditors could, under the old I.R.C. section 382 rules, be considered a purchase, possibly causing the loss of the net operating loss carryover if there was a change in business activity. The concept of "purchase" does not apply to the new I.R.C. section 382 rules. However, any stock received by a nonsecurity creditor will contribute to an ownership shift and a potential limitation of losses under new section 382.

Recall that control under I.R.C. section 351 means ownership of at least 80 percent of the combined voting power of all classes of voting stock and at least 80 percent of each other class of stock.[16] Thus, if more than 20 percent of a debtor's stock is issued in exchange for nonsecurity debt, the entire transaction will fail to qualify under I.R.C. section 351 and may be taxable. The usual definitional difficulties in determining what constitutes a security may, in fact, be increased because of the enactment of I.R.C. section 351(d). The changes will

[13] Rev. Rul. 59-259, 1959-2 C.B. 115.
[14] *Duncan v. Commissioner*, 9 T.C. 468 (1947), *acq.* 1948-2 C.B. 2; Rev. Rul 77-81, 1977-1 C.B. 97.
[15] *See Commissioner v. Carman,* 189 F.2d 363 (2d Cir. 1951), *acq.* 1954-2 C.B. 3.
[16] Rev. Rul. 59-259, 1959-2 C.B. 115.

also affect the valuation process necessary to measure the worth of the debtor corporation's consideration (stock).[17]

The changes to I.R.C. section 351 apply to transactions in both bankruptcy and nonbankruptcy situations.

(c) I.R.C. Section 351(e)

The Bankruptcy Tax Act contained another major revision to I.R.C. section 351 – section 351(e)(2). I.R.C. section 351(e)(2) provides that section 351 will not apply in a bankruptcy or similar case to the extent the stock received by a transferor or debtor in exchange for the assets are used to satisfy the indebtedness of such debtor. In other words, gain or loss is recognized by the debtor upon the transfer of its assets to a controlled corporation to the extent the stock received is transferred to its creditors.[18] The basis for the property, stock, or other securities received is adjusted to reflect the gain or loss recognized. The net effect of this rule is to treat the transaction in the same manner as if the property had been transferred to the creditors, who then transferred the property to a controlled corporation. Note that this restriction would not apply to contributions of capital if the stock received in return is not used to reduce outstanding debt.

The Senate Report indicates that the reason for imposing this limitation is to prevent the incorporation by a debtor of high-basis, low-value assets where a transfer of the assets directly to the creditors, followed by a transfer by the creditor to a controlled corporation, would result in a fair market value basis to the corporation.[19]

(d) I.R.C. Section 351(g)

The Taxpayer Relief Act of 1997 amended I.R.C. section 351 to treat certain preferred stock (nonqualified preferred stock or NQPS) as boot.[20] The transferor receiving such stock is not afforded nonrecognition treatment to the extent NQPS is received. The Conference Report to the 1997 Act states that if NQPS is received, gain but not loss shall be recognized. The Internal Revenue Service Restructuring and Reform Act of 1998 further amended I.R.C. section 351 to clarify that NQPS is treated as boot in a section 351 exchange only if the transferor receives stock that is not treated as boot in addition to the NQPS. If a transferor receives solely NQPS and the transaction in the aggregate is treated as a section 351 exchange,[21] the transferor could recognize a loss and the basis of the NQPS

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[17] Eustice, *supra* note 5 at 40.

[18] Note that the ability to recognize loss may also be limited by provisions such as I.R.C. section 267.

[19] S. Rep. No. 1035, 96th Cong., 2d Sess. 34 (1980).

[20] *See* § 5.2(g) for a more in-depth description of nonqualified preferred stock.

[21] An example of a transaction in which a transferor receives solely NQPS in a transaction that in the aggregate qualifies under I.R.C. section 351 is as follows: Individuals A and B each own 50 percent of the stock of a corporation. Individual A transfers property to the corporation solely for NQPS and Individual B transfers property solely for common stock.

in the hands of the transferor and the property in the hands of the transferee corporation is determined in the same manner as if the transferor received solely other property (i.e., as if the transaction were a taxable section 1001 exchange). The Conference Reports to both the 1997 and 1998 Acts confirm that the NQPS continues to be treated as stock received by the transferor for purposes of qualification of the transaction under I.R.C. section 351, unless Treasury issues regulations that provide otherwise.

§ 7.4 LIQUIDATION

(a) Old I.R.C. Section 337

Prior to the Tax Reform Act of 1986 (TRA 1986), I.R.C. section 337 provided for no gain or loss on the sale or exchange of property pursuant to a 12-month plan of complete liquidation. Moreover, distributions of property to shareholders in complete liquidation were tax-free at the corporate level.[22] This escape from the corporate tax on sales and distribution was known as the *General Utilities* Doctrine, based on the case of *General Utilities and Operating Co. v. Helvering*.[23] Pursuant to a special exception, I.R.C. section 337 permitted an insolvent corporation to avoid recognition of gain on the sale of assets by adopting a plan of complete liquidation after a bankruptcy petition was filed and by transferring all of its assets to creditors or stockholders prior to the termination of the bankruptcy case. In a bankruptcy case, the 12-month requirement did not apply: The period began when the plan of liquidation was adopted and ended when the bankruptcy case terminated.

Effective January 1, 1987, the *General Utilities* Doctrine and I.R.C. section 337 were repealed.[24] Thus, gain (as well as some losses[25]) is recognized when a corporation sells or distributes its assets pursuant to a liquidation.[26] In addition, gain (but not loss) is recognized when a corporation distributes appreciated property as a dividend or in a redemption.[27] Spin-off distributions under I.R.C. section[28] 355 and a complete liquidation of controlled subsidiaries (parent corporation owns 80 percent of the vote and 80 percent of the value[29]) generally continue to be tax-free at both the shareholder and the corporate levels.

[22] I.R.C. sections 337 and 336 provided for no gain or loss subject to statutory recaptures and tax benefit items.

[23] 296 U.S. 200 (1935).

[24] Former I.R.C. section 337 has been revoked but new I.R.C. section 337 has been reconstituted to provide for the circumstances under which a liquidation of a controlled subsidiary to its parent corporations will be tax-free to the subsidiary. *See* I.R.C. § 332.

[25] *See infra* § 7.4(b).

[26] A non-elective transitional rule applied to liquidating sales and distributions of long-term capital assets by certain closely held corporations occurring before January 1, 1989.

[27] I.R.C. § 311(b).

[28] I.R.C. § 355(c).

[29] *See* note 24 *supra.*

(b) Distribution to Certain Related Parties

To prevent shareholders from contributing property with a built-in loss to a corporation prior to liquidation (to offset such loss against the corporate-level gain), I.R.C. section 336(d)(1) precludes loss recognition if the distribution is to a more-than-50-percent shareholder as defined in I.R.C. section 267 and (a) the distribution is not pro rata, or (b) the property being distributed was transferred to the corporation during the previous 5 years (as a contribution to capital or pursuant to I.R.C. section 351).

(c) Examples

The examples that follow illustrate how loss recognition from selected transactions may be disallowed.

EXAMPLE 7.1

Assume T corporation has been owned (since 1995) 60 percent by individual A and 40 percent by individual B (unrelated to A). T's only assets are two parcels of unencumbered real estate. Each parcel has a fair market value of $10 million and an adjusted basis of $15 million. Parcel 1 has been held by T since 1975 and Parcel 2 was an additional contribution to capital one year prior to the complete liquidation of T. If T distributes undivided pro rata interests in Parcels 1 and 2 in 2004, the loss on Parcel 1 will be recognized, because that Parcel was held since 1995 and was subject to a pro rata distribution. However, because Parcel 2 was acquired as a contribution to capital within the past five years *and* because 60 percent of Parcel 2 is distributed to A (a more-than-50-percent shareholder), 60 percent of the loss on Parcel 2 would be disallowed.

EXAMPLE 7.2

If, in Example 7.1, T had sold Parcel 2, distributed the sale proceeds to B, and distributed Parcel 1 to A, the loss on the sale of Parcel 2 would then be recognized by T. The "related person" loss disallowance rules apply only to liquidating distributions.

(d) Loss Reduction

Loss reduction rules (as opposed to total disallowance) are applied to both sales and distributions of property if the loss property is (a) acquired in a section 351 transaction or as a contribution to capital, and (b) acquired as part of a plan a principal purpose of which was to recognize loss by the liquidating corporation.[30] Generally, any loss property acquired within the two years prior to the adoption of the plan of liquidation will be considered acquired as part of a plan for recognition of loss by the corporation. The Committee Reports to TRA 1986 indicate that, upon the issuance of regulations, the two-year presumption will be disregarded, "*unless* there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future busi-

[30] I.R.C. § 336(d)(2).

ness enterprises."[31] The loss reduction rules only apply if the fair market value of the loss property is less than its adjusted basis at the time of its acquisition by the corporation.

EXAMPLE 7.3

Assume that X corporation (100 percent owned by A) acquires nondepreciable property in an I.R.C. section 351 transaction that has a carryover basis of $1,000 and fair market value of $100 on June 1, 1999. Assume that a principal purpose of the acquisition by X was to recognize loss and offset corporate-level gain in anticipation of a complete liquidation. The property is sold to an unrelated third party on September 30, 1999, for $200, and a plan of liquidation is adopted on November 30, 1999. No loss is recognized upon the sale, because the basis is reduced to $100 for purposes of the loss computation:

Transferred basis	$1,000
Excess basis over FMV at contribution date	(900)
Basis for loss computation	$100
Cash received	$200

However, for gain computation, the basis remains at $1,000 and thus no gain is recognized.

The purpose of the loss reduction rule is to prevent "stuffing" a corporation with loss property prior to a complete liquidation, in order to offset other gains. Thus, this rule denies recognition of any losses accrued *prior* to the contribution of loss property, but permits recognition of any loss accruing after the contribution. If both the loss reduction provisions and related party provisions apply, the related party provisions will prevail and will allow no recognition of loss.

(e) I.R.C. Section 332

As described above, in general a liquidation is treated as a taxable distribution of assets by the liquidating corporation to its shareholders and a taxable receipt of those assets by the shareholders in exchange for their stock in the liquidating corporation. More favorable tax treatment is available for a liquidation of a subsidiary corporation into its parent corporation in conformance with the requirements of I.R.C. section 332. I.R.C. section 332 generally requires a liquidating distribution from a solvent corporation to an 80-percent owned distributee corporation within a prescribed time frame. The 80-percent ownership requirement is defined for this purpose in I.R.C. section 1504(a)(2) as ownership of 80 percent of the voting power and 80 percent of the value of all stock, excluding so-called vanilla preferred stock, defined in I.R.C. section 1504(a)(4). The solvency requirement may be more complicated. In fact, a corporation may need to be *more than* solvent to qualify for section 332 treatment. For example, assume that a solvent subsidiary corporation, which has assets with a fair market value in

[31] H.R. Rep No. 841, 99th Cong., 2d Sess. II-201 (1986).

excess of its indebtedness, has two classes of stock outstanding, nonvoting preferred stock and common stock. Parent owns 100 percent of both classes of stock. In liquidation, the parent of the subsidiary receives assets of the subsidiary with a value that is less than the liquidating preference of the preferred stock. Because the subsidiary distributed all its assets with respect to its preferred stock and no assets with respect to its common stock, the liquidation will likely not qualify for section 332 treatment because there has not been a distribution with respect to all its stock.[32]

An insolvent subsidiary cannot be made solvent, prior to its liquidation, by having its parent cancel a debt due from the subsidiary.[33] The liquidation of an insolvent subsidiary, however, entitles its parent to claim a bad debt deduction under I.R.C. section 166 and possibly a worthless stock deduction under I.R.C. section 165(g)(3).[34]

If a transaction satisfies the section 332 requirements, then under I.R.C. section 337(a), no gain or loss is recognized to a corporation that liquidates under I.R.C. section 332 to an 80-percent distributee. Although the liquidating corporation can recognize gain on a liquidating distribution to a minority shareholder, section 336(d) prevents the liquidating corporation from recognizing a loss on such a distribution. The Omnibus Budget Reconciliation Act of 1987 revised I.R.C. section 337(c) to require that, in determining whether there is a liquidation to an 80-percent distributee, the consolidation return regulations (and in particular the aggregate ownership rules of Treas. Reg. section 1.1502-34) *cannot* be used.

Thus, a liquidation of S into its 100 percent shareholder, P, results in no gain or loss to P or S. If, however, S is owned equally by P (parent of a consolidated group) and X (a wholly owned subsidiary of P and a member of the P consolidated group), the liquidation of S into P and X is tax-free to P and X (Treas. Reg. section 1.152-34 continues to apply for purposes of I.R.C. section 332), but S will be taxed (I.R.C. section 337(a) is applied without regard to the aggregation rules of Treas. Reg. section 1.1502-34).[35] The gain at the S level is an intercompany item subject to the recognition rules of Treas. Reg. section 1.1502-13.

If, in the above example, P owned 80 percent of S and X owned 20 percent, I.R.C. section 337(a) would protect the portion of the liquidating distribution made to P, but a deferred gain would result to S on the portion of the distribution to X (triggered under the same circumstances as above).[36]

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[32] *See Commissioner v. Spaulding Bakeries, Inc.*, 252 F.2d 693 (2d Cir. 1958); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).

[33] Rev. Rul. 68-602, 1968-2 C.B. 135.

[34] Rev. Rul. 2003-125, 2003-52 I.R.B. 1. *See also* Private Letter Ruling 9425024 (Mar. 25, 1994) (allowing deductions under I.R.C. sections 165(g)(3) and 166). *See also* discussion at Chapter 6, n.11.

[35] *See* I.R.C. section 337(c).

[36] The Conference Report provides that, where an 80-percent corporate shareholder and a 20-percent corporate shareholder receive a liquidating distribution, the deferred gain of the 20-percent shareholder on the portion of the assets distributed to it would be triggered when the 80-percent shareholder leaves the group. H.R. Conf. Rep. No. 100-495, at 969 (1987).

The deferred gain in a consolidated context and an immediate gain or loss in a nonconsolidated context can be avoided if, in the above example, where P and X jointly own all of the stock of S and P owns 100 percent of X, X liquidates into P prior to S liquidating into P.

The I.R.C. section 332 changes were made to prevent the use of "mirror subsidiaries"[37] to avoid the repeal of the *General Utilities* Doctrine. The changes also affect an "old and cold" ownership of a subsidiary that liquidates into multiple members of a consolidated group. It appears that the intent is to grandfather all mirror structures established before December 15, 1987.

§ 7.5 I.R.C. SECTION 338

A common objective of corporate acquisitions is to obtain the assets of the acquired corporation ("target") at a basis equal to their fair market value. This objective is easily achieved by purchasing the target's assets. Often, however, the shareholders of the target prefer to sell their stock rather than authorize the target to sell its assets. If stock of the target is purchased, I.R.C. section 338 provides an election mechanism to achieve a step-up in the basis of assets.

(a) Reasons for I.R.C. Section 338

The 1982 enactment of I.R.C. section 338 was rooted in certain inequities and complexities inherent in the application of its predecessor, I.R.C. section 334(b)(2). I.R.C. section 334(b)(2) required, as a prerequisite to basis step-up, that the target be completely liquidated. If the acquiring corporation found it desirable to operate the business of the target as a subsidiary, it would be frustrated by the requirement to liquidate the target. Any attempt to "drop down" the target assets after a complete liquidation ran the risk of being challenged under the concept of liquidation-reincorporation as less than a complete liquidation,[38] and thus of failing to qualify under I.R.C. section 334(b)(2) for the desired basis step-up. Although a complete liquidation of the target was required under I.R.C. section 334(b)(2), this liquidation could occur five years or more after the date the stock was purchased.[39] The operations of the target during this interim period (the time between the purchase of stock and the liquidation) resulted in certain adjustments to the basis of the target stock in the hands of the purchasing corporation[40] and, hence, to the basis of the assets received in the ensuing liquidation. These "interim adjustments" were among the most complex and misunderstood rules of corporate taxation and could, in fact, result in a higher basis than if the target's assets had been purchased directly. Because of these complexities, and to provide a more flexible elective regime, Congress chose to repeal I.R.C. section 334(b)(2) and replace it with I.R.C. section 338. Unfortunately, I.R.C. section 338 falls short of its goal of simplicity.

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[37] *See* Bloom, Buying and Selling Corporations After Tax Reform, 14 *J. Corp. Tax'n* 167, 170 (1987).

[38] Rev. Rul. 76-429, 1976-2 C.B. 97.

[39] Rev. Rul. 71-326, 1971-2 C.B. 177.

[40] Treas. Reg. § 1.334-(c)(4), *removed by* T.D. 8474, 58 Fed. Reg. 25556 (Apr. 27, 1993).

(b) Applicability of I.R.C. Section 338

Because, as described below, a section 338(g) election results in a deemed taxable sale of assets, the repeal of the *General Utilities* Doctrine under TRA 1986 has substantially reduced the usefulness of I.R.C. section 338. Although the section remains intact, there will be few situations in which the corporate purchaser of a target corporation will choose to pay tax (on the appreciation in all target assets, not just recaptures) merely to receive a step-up in basis for certain depreciable assets. However, I.R.C. section 338 and the regulations promulgated thereunder have continued importance in three respects:

1. If the target corporation has expiring net operating losses, or assets whose basis exceeds their fair market value, or is a foreign corporation not subject to U.S. tax losses, the deemed sale of target's assets pursuant to the I.R.C. section 338 election may not be too costly, because any gain will be offset by those losses.
2. The adoption of the residual method for allocating goodwill (discussed below) and the mandatory use of that method, even if assets are purchased from noncorporate sellers, requires an understanding of the regulations under I.R.C. section 338(b).
3. A special election under I.R.C. section 338(h)(10) (discussed below) permits specified sellers of stock to treat the sale as a sale of assets.

As described in greater detail below, section 338 has been fertile ground for regulatory development, with the result that the applicable rules vary considerably depending on the tax years at issue. The discussion below will provide a broad overview of the section 338 rules and will then be followed by a discussion of significant regulatory developments.

(c) "Qualified Stock Purchase"

The threshold requirement for obtaining a fair market value basis under section 338 is to make a "qualified stock purchase."[41] A qualified stock purchase is an acquisition by purchase by one corporation (and other members of its affiliated group) of stock in another corporation possessing at least 80 percent of the voting power and at least 80 percent of the value of the total stock of the purchased corporation. This purchase must occur during a 12-month acquisition period.[42]

To acquire a target's stock by purchase, the purchasing corporation must not acquire it (1) from a related party whose ownership of the target stock would be attributed to the purchasing corporation under I.R.C. section 318(a) (applied without certain of the section 318 attribution rules); (2) in an exchange described in I.R.C. sections 351, 354, 355, or 356; or (3) in a transaction in which the purchasing corporation's basis is determined in whole or in part by the basis of the "seller" in the target stock.[43] There are several exceptions to these general rules

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[41] I.R.C. § 338(a).

[42] I.R.C. § 338(d)(3); I.R.C. § 1504(a)(2).

[43] I.R.C. § 338(h)(3).

for stock acquired from a related corporation which was itself recently acquired in whole or in part in a taxable purchase.

(d) 12-Month Acquisition Period

The 12-month acquisition period is the 12-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase.[44] Suppose Corporation X makes the following cash purchases of Corporation Y's stock from unrelated individuals. On January 10, 2000, Corporation X purchases 10 percent; on March 20, 2000, an additional 5 percent; on December 1, 2000, an additional 60 percent; on January 30, 2001, an additional 15 percent, and the remaining 10 percent on February 25, 2001. The 12-month acquisition period would begin on March 20, 2000, because, between March 20, 2000, and March 20, 2001, Corporation X would have acquired by purchase 90 percent of Corporation Y's stock (X did not acquire 80 percent of the Y stock during the 12-month period beginning January 10, 2000). The day within the 12-month acquisition period on which the purchasing corporation acquires the requisite percentage of the target's stock to achieve a qualified stock purchase is the acquisition date.[45] In this example, January 30, 2001, would be the acquisition date.

(e) Impact of a Section 338(g) Election

The filing of a section 338(g) election has the following results: The target is treated, for federal income tax purposes, as if it sold all its assets for fair market value at the close of the acquisition date in a single taxable transaction, and the target is treated, as of the beginning of the day after the acquisition date, as a new corporation that purchased all those assets.[46] The deemed sale by target of its assets will cause the target to recognize income based on the difference between the fair market value of the assets in the target's hands and the basis of those assets in the target's hands. The deemed sale is a sale from target (Old T) to itself (New T). Old T is treated as having sold all of its assets for an amount designated as the aggregate deemed sales price (ADSP), and New T is treated as having purchased those assets for an amount designated as the adjusted grossed-up basis (AGUB).

In general, ADSP is the sum of (1) the amount realized on the sale of the target stock to the purchasing corporation and (2) the liabilities of Old T.[47] In general, the liabilities of the Old T are the liabilities of target (and the liabilities to which the target assets are subject) as of the beginning of the day after the

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[44] I.R.C. § 338(h)(1).

[45] I.R.C. § 338(h)(2).

[46] I.R.C. §§ 338(a)(1) and (a)(2).

[47] Treas. Reg. § 1.338-4(b). For acquisitions before January 6, 2000, see former Treas. Reg. 1.338-3, which among other things, linked the determination of ADSP to the purchasing corporation's basis in the target stock, and included an adjustment for "other relevant items." The former regulations did not always reflect the amount of gain and timing of gain under general tax principles. These issues were corrected in the Temporary Regulations; *see* §7.5(h)(ii).

acquisition date. To be taken into account in ADSP, a liability must be one that would be taken into account in an amount realized under general principles of tax law had target sold its assets to an unrelated purchaser for consideration that included an assumption by the purchaser of the liabilities of the target (or a purchaser's taking of assets subject to target liabilities). For example, ADSP includes the tax liability for the deemed sale gain, unless the tax liability is borne by some person other than the Target.

In general, the deemed purchase price (the AGUB) is equal to the purchasing corporation's basis in the target stock, adjusted for liabilities of the target as of the beginning of the day after the acquisition date (including income tax liability resulting from the deemed sale of its assets under I.R.C. section 338(a)(1)).[48] This purchase price is then allocated to the assets of the target using a residual approach. That approach, which was introduced into the law by TRA 1986, mandates the residual method for allocating goodwill (including the entire basis allocation regulations of I.R.C. section 338) for an asset acquisition of a business. Thus, to provide consistency, the section 338 basis rules are applicable when (1) 80 percent of the target's stock is purchased and a section 338(g) election is made, (2) the purchasing corporation acquires all of the target's assets, or (3) the purchasing corporation acquires one of the seller's many businesses (whether or not the seller is a corporation). If the purchasing corporation has made a qualified stock purchase (i.e., at least 80 percent of the required classes of stock) but has not purchased 100 percent of the target's stock, an additional refinement reflecting a grossing-up of the price of recently purchased target stock must be made to its basis in the target stock.[49]

Prior to 1982, this income could be offset by using losses of the purchasing corporation or other corporations included in a consolidated return with the purchasing corporation and target. However, pursuant to I.R.C. section 338, the target's deemed sale of assets is not includable in the purchasing corporation's consolidated return.[50] The deemed sale is includable in the target's final separate return where the target is not a member of a consolidated return group and is includable in the target's final consolidated return where the target is the common parent of a consolidated return group.[51] Finally, the deemed sale is not includable in a consolidated return where the target is not the common parent of the consolidated return group. Instead, the target is disaffiliated from its group

[48] Treas. Reg. § 1.338(b)-5(b). For acquisitions before January 6, 2000, this amount was also adjusted for "other relevant items (items that might cause the deemed purchase price to improperly reflect the actual cost of the purchasing corporation's interest in the target's assets)." This language was rendered obsolete by new temporary regulations. Former Treas. Reg. § 1.338-1(f) and (g). *See* § 7.5(h)(ii).

[49] I.R.C. § 338(b)(1) and (4).

[50] Treas. Reg. § 1.338-10(a)(5). The effect of excluding the target from any consolidated return, where it is not the common parent, is that in the year the target's stock is sold it may be required to file three tax returns. One return would include the target in the affiliated group of the selling corporation; one return would include it in the affiliated group of the purchasing corporation; and a third return would be required for the date of the deemed asset sale (the acquisition date), to account for the income occasioned by the deemed sale.

[51] Treas. Reg. § 1.338-10(a)(1).

immediately before the deemed sale and includes the deemed sale in a separate "deemed sale return."[52]

(f) Consistency Rules

As originally enacted, I.R.C. section 338 was concerned with consistent treatment if a purchasing corporation acquired assets of the target (or an affiliate) at the same time that it made a qualified stock purchase of the target stock, or if a purchasing corporation acquired the stock of two or more members of an affiliate group. These rules are less important than they were prior to the repeal of the *General Utilities* Doctrine, but they survive in altered form. Proposed consistency regulations were finalized on December 22, 1993 (effective for targets with acquisition dates on or after January 20, 1994).[53] The final regulations under I.R.C. section 338 restate, simplify, and substantially shorten the previous version of the regulations. Substantive changes were made in the stock and asset consistency rules under I.R.C. section 338(e) and (f), in an effort to simplify their application and narrow their scope. Gone from the lexicon are the concepts of protective carryover basis election, affirmative action carryover election, unincluded company asset acquisition, intercompany consolidated asset acquisition, and offset prohibition election. The following discussion focuses on the asset and stock consistency rules under current Treas. Reg. section 1.338-8.

With the repeal of the *General Utilities* Doctrine, the old consistency rules no longer served their intended purpose of preventing "cherry picking" of assets from target corporations without attendant tax costs. Because a basis step-up is accompanied by full gain recognition, the utility of the old consistency rules was greatly diminished. As a result, the final consistency rules address only limited circumstances where selectivity of asset or stock purchases may provide potential tax advantages to a purchaser.

Under the current rules, an acquisition by the buyer of (1) stock in a qualified stock purchase and (2) an asset from the target, during the consistency period, will not deem or require a section 338 election to occur. Instead, the asset will have a cost basis unless the consistency rules require a carryover basis (the "carryover basis rule"). This is a simple general rule. However, in the few situations where a taxpayer seeks to circumvent the rules, a complex and convoluted set of "indirect acquisition" rules alters the carryover basis rule.

Generally, the consistency rules operate in the context of a consolidated return to prevent acquisitions from being structured to take advantage of the investment adjustment rules of Treas. Reg. section 1.1502-32. Under the carryover basis rule, an asset must take a carryover basis if:

- The asset is disposed of during the target consistency period;

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[52] Treas. Reg. § 1.338-10(a)(2).

[53] T.D. 8515, 59 Fed. Reg. 2958 (Jan. 20, 1994). The final regulations also apply on an elective basis to targets with acquisition dates on or after January 14, 1992, and before January 20, 1994. *See* former Treas. Reg. § 1.338(i)-1 and current Temp. Reg. § 1.338(i)-1T. If such an election is made, a protective carryover basis election or an offset prohibition election made under the temporary regulations will have no effect.

- The basis of the target stock reflects gain from the disposition of the asset; and
- The asset is owned, immediately after its acquisition and on the target acquisition date, by a corporation that acquires stock of target in the qualified stock purchase (or by an affiliate of an acquiring corporation).

The carryover basis rule generally applies to direct acquisitions of assets from T, a subsidiary in a consolidated group, by P, the purchaser (or an affiliate of P), during T's consistency period. The rule also applies to assets acquired from lower-tier T affiliates or certain conduits, if gain from the sale is reflected in the basis of the T stock under Treas. Reg. section 1.1502-32.

EXAMPLE 7.4

Seller (S) and T file a consolidated return. S has a $100 basis in the T stock, which has a fair market value of $200. T sells an asset to P and recognizes $50 of gain. S's basis in the T stock is increased from $100 to $150. Within the consistency period, S sells the T stock to P for $200 and recognizes a gain of $50. No section 338 or 338(h)(10) election is made.

The consistency rules apply in this example because, under Treas. Reg. section 1.1502-32, T's gain on the asset sale is reflected in S's basis in the T stock. P must take a carryover basis in the asset acquired from T. The District Director no longer has the discretion to impose a deemed section 338 election for T. Thus, under the regulations, the integrity of the stock purchase is maintained. The protective carryover election is rendered inoperative and, accordingly, has been removed from the regulations.

In Example 7.4, P may make a section 338 election or a section 338(h)(10) election to treat the purchase of the T stock as an asset acquisition, and thus maintain a cost basis in the directly acquired asset.

The consistency rules also apply where a 100-percent dividends-received deduction (DRD) is used in conjunction with an asset disposition to achieve a result similar to that available under the investment adjustment rules. If the dividend paid during the consistency period that ends on the target acquisition date, and to which the 100-percent DRD is taken, exceeds the greater of $250,000 or 125 percent of the yearly average amount of dividends paid during the prior three years, the consistency rules apply.

EXAMPLE 7.5

S does not file a consolidated return with T. In 1989, 1990, and 1991, T pays dividends to S that average $300,000. In 1992, T sells an asset to P and recognizes gain. Within the consistency period, P makes a qualified stock purchase of T from S and no section 338 election is made. During the consistency period ending on the acquisition date, T pays S a dividend of $1 million that qualifies for the 100-percent DRD. The consistency rules apply in this example to limit P to a carryover basis in the asset acquired.

(g) Elective Recognition of Gain or Loss by Target Corporation: I.R.C. Section 338(h)(10)

A section 338(g) election by a purchasing corporation has no effect on the seller of the target corporation, which treats the disposition of the target as a stock sale. I.R.C. section 338(h)(10) allows the purchasing corporation and specified sellers to make a joint election to permit the seller as well as the purchaser to treat the stock sale as an asset sale by the target corporation. The specified sellers are sellers that could have liquidated target and then sold its assets (or sold target and then liquidated) without incurring two levels of tax. Under former temporary regulations, the election was only available for a member of a consolidated group other than the common parent. Former final regulations, applicable to acquisition dates on or after January 20, 1994, or before January 6, 2000, added two previously excluded targets: S corporations and nonconsolidated affiliates. The new final regulations retain the same types of targets for which a section 338(h)(10) election can be made.[54]

As a result of a section 338(h)(10) election, the target is treated as selling all of its assets to an unrelated party in exchange for consideration that includes the assumption of or taking subject to liabilities in a single transaction at the close of the acquisition date, but while the target was a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders).[55] After the deemed asset sale and while target is a member of the consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders), target is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or the S corporation shareholders and as if it ceased to exist.[56] Note that target remains liable for the tax liabilities of "old target," including the tax liability for the deemed sale gain.[57]

Generally, the section 338(h)(10) election is attractive to a selling corporation if its basis in target stock is less than, equal to, or not substantially greater than the target's net basis in its assets (aggregate basis of assets less liabilities). Use of a section 338(h)(10) election will also be beneficial if the selling group (and in particular the target) has net operating losses, which can "shelter" the target's gain on its hypothetical asset sale. Finally, the seller can distribute the proceeds of a section 338(h)(10) sale to its own shareholders in a transaction that may qualify as a partial liquidation.[58] In addition, if target distributes assets to the seller prior to the

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[54] Treas. Reg. § 1.338(h)(10)-1(c). For S corporations, a section 338(h)(10) election can be made if target is an S corporation immediately before the acquisition date. The deemed sale gain is reported on T's final S corporation return and, therefore, affects a target shareholder's basis in the target, including shareholders of the S corporation that do not sell their stock. *See* Treas. Reg. § 1.338(h)(10)-1(d)(5). Thus, all shareholders of the target S corporation must sign Form 8023, Elections Under Section 338 for Corporations Making Qualified Stock Purchases. Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2).

[55] Treas. Reg. § 1.338(h)(10)-1(d)(3).

[56] Treas. Reg. § 1.338(h)(10)-1(d)(4).

[57] Treas. Reg. § 1.338(h)(10)-1(d)(2).

[58] Private Letter Ruling 9007036 (Nov. 20, 1989).

sale of target stock for which a section 338(h)(10) election is made, the distribution may be treated as part of a deemed tax-free section 332 liquidation of target.[59] Neither a straight section 338 election nor a mere sale of stock will so qualify.[60]

EXAMPLE 7.6

Assume S Corporation owns all the outstanding stock of T Corporation, holding assets with a basis of $5 million and a fair market value of $10 million. On February 3, 1994, S sells all of the T stock to P for $10 million. On November 15, 1994, S and P jointly make a section 338(h)(10) election.

As a result of the section 338(h)(10) election, no gain or loss is recognized by S on the actual sale of T stock to P. T is considered to have sold all its assets to New T (owned by P) in a taxable transaction. The entire $5 million of gain[61] incurred by T is reported in the S/T consolidated return for the year, including the acquisition date of T. Thus, S losses can offset the T gain.

(h) Regulatory Evolution

(i) Acquisition Dates After February 13, 1997, and Before February 6, 2000

In 1993, Congress added section 197 (Amortization of Goodwill and Certain Other Intangibles) to the I.R.C. Prior to the enactment of I.R.C. section 197, amortization of the cost of an intangible asset was permitted only if the asset was distinct from goodwill or going concern value and the asset had a determinable useful life that could be estimated with reasonable accuracy. I.R.C. section 197 allows taxpayers to amortize certain acquired intangible assets over 15 years.

The report of the House Committee on Ways and Means accompanying the 1993 Act states that the drafters of I.R.C. section 197 anticipated that the residual method specified in the I.R.C. section 1060 and 338(b) regulations then in effect would be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification would apply to any acquisition of property to which I.R.C. section 197 applies.[62] The regulations referred to in that legislative history generally provided for a residual method of allocation of purchase price, which placed an acquired asset into one of four asset classes. No asset in any class except for the last class could be allocated more than its fair market value. The four classes specified by the regulations were:

Class I Cash and cash equivalents

Class II Certificates of deposit, U.S. government securities, readily marketable stocks and securities, and foreign currency

Class III All assets not in Class I, II, or IV

Class IV Intangible assets in the nature of goodwill and going concern value

[59] Private Letter Ruling 9738031 (June 24, 1997).
[60] *See* Rev. Rul. 75-223, 1975-1 C.B. 109.
[61] Note the actual gain is based on a formula set forth in Treas. Reg. sections 1.338(h)(10)-1(d).
[62] H.R. Rep. No. 111, 103d Cong., 1st Sess. 760, 776 (1993).

On January 16, 1997, the IRS issued various amendments (the "allocation amendments") to the final and temporary section 1060 and section 338(b) regulations providing for a change in the method of allocating the purchase price among the intangible assets of an acquired trade or business.[63] With a minor modification, these amendments conform the current regulations to the 1993 Act legislative history. The amendments place amortizable section 197 intangibles in Class IV, but they modify the treatment of goodwill and going concern value slightly. According to the allocation amendments, all section 197 intangibles except goodwill and going concern value (whether amortizable or not), are placed in Class IV, and goodwill and going concern value (whether amortizable or not) are placed in a new class, Class V.

The rationale for excluding goodwill and going concern value from Class IV is that, generally, when a buyer purchases assets subject to I.R.C. section 197, those assets can become amortizable section 197 intangibles even though they were not amortizable in the hands of the sellers. If the 1993 legislative history were applied literally, the seller would include the asset in Class III and the buyer would include the asset in Class IV. This rule would result in inconsistent reporting positions between the buyer and the seller. Citing strong policy concerns, including mandatory application of the rule of *Commissioner v. Danielson*,[64] the IRS determined, and these amendments require, that all section 197 intangibles (other than goodwill and going concern value), whether amortizable or not, are to be placed in Class IV.

The rationale for placing goodwill and going concern value in a true residual class, Class V, is that the IRS was concerned that placing all I.R.C. section 197 intangibles (including goodwill and going concern value) in Class IV would require taxpayers to determine the fair market value of goodwill and going concern for purposes of allocating purchase price to all the Class IV assets. The IRS was also concerned that if all section 197 intangibles were included in the most junior class, an allocation of purchase price could result in allocating more than fair market value to each of the intangible assets in that class, possibly resulting in an unwarranted deferral of gain upon the sale of one of these assets.

With the enactment of section 197, many believed that the need to separately determine the fair market values of intangible assets had been eliminated. These allocation amendments reintroduce the requirement that separate values be determined, at least with respect to the intangibles that are severable from an ongoing business.

(ii) Acquisition Dates On or After January 6, 2000

In January 2000, the IRS and Treasury Department issued new temporary regulations under I.R.C. sections 338 and 1060, effective for transactions occurring on or after January 6, 2000.[65] The new temporary regulations removed and replaced many of the former temporary and final regulations under I.R.C. sections 338

[63] T.D. 8711, 62 Fed. Reg. 2267 (Jan 16, 1997).
[64] 378 F.2d 771 (3d Cir. 1967).
[65] T.D. 8858, 65 Fed. Reg. 1236 (Jan. 7, 2000).

and 1060. The new temporary section 1060 regulations incorporated the new temporary section 338 regulations by cross-reference.

The new temporary regulations retained the residual method for purposes of allocating purchase price to target's assets. The new temporary regulations, however, increased the number of asset classes from five to seven, adding new classes for receivables arising in the ordinary course of business and for inventory-type property. In particular, Old Class III (the all-other-assets category) is subdivided into new Classes III, IV, and V.[66] The new classes are:

Class I: Cash and cash equivalents

Class II: Actively traded personal property (as defined in section 1092(d)), foreign currency, and certificates of deposit

Class III: Accounts receivables and other receivables arising in the ordinary course of business

Class IV: Stock in trade and inventory

Class V: All assets not otherwise covered

Class VI: Section 197 assets (except goodwill and going concern value)

Class VII: Goodwill and going concern value[67]

The two new classes are intended to mitigate the phantom-income problem that existed under the former regulations. Under the former regulations, if the purchaser used contingent consideration, the former residual method sometimes caused certain assets to not have basis allocated in an amount equal to their fair market value. If these assets were sold, the purchaser realized gain on the disposition, even if the asset values had not changed since the acquisition date of the target stock. In later years, if the purchaser paid additional amounts for the target stock, the purchaser could receive a deduction to offset the effect of the gain recognized. The "over recognized" gain was commonly referred to as phantom income. The phantom-income problem was most acute for assets that turned over quickly.

The temporary regulations also altered the definitions of ADSP and AGUB, described above, and eliminated the concept of modified aggregate deemed sales price (MADSP), which was a modified version of ADSP previously applicable to section 338(h)(10) elections. And, as described above, the temporary regulations removed a previous linkage between ADSP and AGUB that effectively afforded a target company so-called "open transaction" treatment, contrary to general tax principles.

(iii) Current Final Regulations

Effective March 16, 2001, T.D. 8940[68] adopted with modifications the proposed regulations published on August 10, 1999, and the temporary regulations

[66] Former Temp. Treas. Reg. § 1.338-6T(b).
[67] *See* discussion below in § 7.5(h)(iii) of modifications to several classes of assets in the final regulations.
[68] T.D. 8940, 66 Fed. Reg. 9925 (Feb. 13, 2001).

(T.D. 8858)[69] published on January 7, 2000. Several of the changes included in the new final regulations are summarized below.

The proposed and temporary regulations included an anti-abuse rule to prevent taxpayers from changing the results of the residual method by engaging in asset-stuffing or asset-stripping transactions that have a transitory economic effect with respect to the ownership or use of assets. Although the anti-abuse rule is retained, several changes have been made to clarify its intended scope.[70]

The final regulations add a new rule clarifying that the "next day rule" of Treas. Reg. section 1.1502-76(b) applies in a section 338 context. The "next day rule" provides that if, on the day of a consolidated group member's change in status as a member, a transaction occurs that is properly allocable to the portion of the member's day after the event resulting in the change, the member and all related persons must treat the transaction as occurring at the beginning of the following day. Under the new rule, if a section 338 election is made for target and target engages in a transaction outside the ordinary course of business on the acquisition date, the transaction is treated as occurring at the beginning of the day following the transaction and after the deemed asset purchase by new target.[71]

The proposed regulations contained a definition of "purchase" requiring more than a nominal amount be paid for the target stock to have a qualified stock purchase. The temporary regulations reserved on the issue. The final regulations do not contain the more-than-nominal-amount requirement. Rather, target stock (or target affiliate stock) is considered purchased if, under general principles of tax law, the purchasing corporation is considered to own stock.[72]

The final regulations provide a new rule that the acquisition of target stock for consideration other than voting stock will not prevent the subsequent transfer of target assets to the purchasing corporation (or another member of the affiliated group) from qualifying as a "C" reorganization.[73]

The final regulations confirm the changes to ADSP and AGUB described above, clarifying in the preamble to the final regulations that a tax liability generally is treated like any other type of liability for purposes of computing ADSP and AGUB.[74]

The final regulations remove the following language contained in the proposed and temporary regulations: "[in] certain cases, the IRS may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets." Nevertheless, according to the preamble, the IRS retains the ability to challenge a taxpayer's valuation of assets in Classes I through VI, but will do so on grounds consistent with the residual method of allocation.[75]

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[69] T.D. 8858, 65 Fed. Reg. 1236 (Jan. 7, 2000).
[70] *See* Treas. Reg. § 1.338-1(c).
[71] *See* Treas. Reg. § 1.338-1(d).
[72] *See* Treas. Reg. § 1.338-3(b)(2).
[73] *See* Treas. Reg. § 1.338-3(d)(4). *See also* Chapter 5 n. 42.
[74] *See* Treas. Reg. §§ 1.338-4(d) and 1.338-5(e).
[75] T.D. 8940, 66 Fed. Reg. 9925, 9926-27 (Feb. 13, 2001) (preamble). *See* Treas. Reg. § 1.338-6(a)(iii).

The final regulations continue to apply the "top-down" allocation system. Under this system, stock of a lower-tier subsidiary is allocated purchase price in the general asset category (Class V). The deemed purchase price of that lower-tier subsidiary's assets is in turn computed from the amount allocated to its stock. The final regulations modify the scope of Class II assets (i.e., generally meaning actively traded personal property) providing that Class II assets do not include stock of target affiliates, other than actively traded stock described in I.R.C. section 1504(a)(4) (certain preferred stock).[76]

The final regulations expand the category of assets that are Class III assets. Under the proposed and temporary regulations, Class III assets generally consisted of accounts receivable, mortgages, and credit card receivables. Under the final regulations, Class III assets generally are assets that a taxpayer marks to market at least annually and certain debt instruments, excluding debt instruments issued by a related person and certain contingent payment and convertible debt instruments.[77]

The final regulations remove the rules providing special treatment for changes in ADSP and AGUB occurring before the close of new target's first tax year. Rather, the general redetermination rules of Treas. Reg. section 1.338-7 apply to the allocation of all changes of AGUB and ADSP that occur after the acquisition date of target. Treas. Reg. section 1.338-7(a) provides that ADSP and AGUB are redetermined at such time and in such manner as an increase or decrease would be required under general principles of tax law for the elements of ADSP and AGUB.[78]

The final regulations address several issues related to S corporation targets. First, a payment of varying amounts to S corporation shareholders in a transaction for which a section 338(h)(10) election is made will not cause the S corporation to violate the single-class-of-stock requirement, provided that varying amounts are determined at arm's length negotiations with the purchaser.[79]

(iv) T.D. 9071

In July 2003, the IRS and Treasury released final and temporary regulations (T.D. 9071)[80] that provide generally that if a section 338(h)(10) election is made as part of a multi-step transaction, the purchasing corporation's acquisition of target stock will be treated as a qualified stock purchase for all federal income tax purposes, even if the overall transaction would otherwise be integrated and treated as a tax-free reorganization in the absence of a section 338(h)(10) election.

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[76] *See* Treas. Reg. § 1.338-6(b)(2)(ii).

[77] *See* Treas. Reg. § 1.338-6(b)(2)(iii).

[78] For an application of general principles of tax law concerning the tax treatment of contingent consideration, *see Meredith Corp. v. Commissioner,* 108 T.C. 89 (1997).

[79] *See* amendment to Treas. Reg. section 1.1361-1(2)(v). T.D. 8940, 66 Fed. Reg. 9925 (Feb. 13, 2001). This amendment is consistent with the IRS's informal ruling policy. *See* Private Letter Ruling 199918050 (Feb. 9, 1999).

[80] T.D. 9071, 68 Fed. Reg. 40766 (July 9, 2003).

These regulations were forecast by Revenue Ruling 2001-46[81] in which the IRS applied the step-transaction doctrine to treat a series of transactions occurring pursuant to a single plan—encompassing a first step acquisition merger of a subsidiary of acquiring into target that would otherwise constitute a qualified stock purchase, followed by a second step upstream merger of target into acquiring—as a single statutory merger of target into acquiring.

In Situation 1 of Rev. Rul. 2001-46, corporation X owned all of the stock of newly formed Y. Pursuant to an integrated plan, X acquired all of the stock of T (an unrelated corporation) in a statutory merger of Y into T (the "Acquisition Merger") with T surviving. In the Acquisition Merger, the T shareholders exchanged T stock for consideration consisting of 70 percent X voting stock and 30 percent cash. After the Acquisition Merger, and as part of the plan, T merged into X in a statutory merger (the "Upstream Merger").

The ruling provides that if viewed separately from the Upstream Merger, the Acquisition Merger would qualify as a qualified stock purchase. However, in Rev. Rul. 2001-46 the IRS applied the step transaction doctrine to the Acquisition Merger and the Upstream Merger, treating the integrated transaction as an acquisition by X of all of T's assets in a single statutory merger qualifying as a reorganization under section 368(a).

As contemplated by Rev. Rul. 2001-46, T.D. 9071 adopts new final and temporary regulations to give effect to section 338(h)(10) elections in multi-step transactions in which the purchasing corporation's acquisition of the target's stock, viewed independently, constitutes a qualified stock purchase.

The final and temporary regulations are applicable to acquisitions of stock occurring on or after July 9, 2003. The regulations provide taxpayers flexibility in structuring and planning the tax consequences of an acquisition, and represent a novel approach by the Treasury in which tax-free reorganization treatment is, in certain circumstances, elective.

(i) Election Procedures

An election to be treated under I.R.C. section 338 must be filed by the purchasing corporation on Form 8023, Elections Under Section 338 for Corporations Making Qualified Stock Purchases.[82] The final regulations indicate that the IRS will recognize the validity of otherwise valid section 338(h)(10) elections made on the 1997 version of Form 8023 (Elections Under Section 338 for Corporations Making Qualified Stock Purchases) not signed by non-selling S corporation shareholders, provided the S corporation target and all of its shareholders report the tax consequences consistent with the results of section 338(h)(10).[83] Revised Form 8023 and Form 8883 reflect changes made by the final regulations. Revised Form 8023 also reflects the requirement that certain information now be

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[81] 2001-2 C.B. 321.

[82] *See* Treas. Reg. § 1.338-2(d). A section 338 election, which is irrevocable, must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

[83] *See* Treas. Reg. § 1.338(i)-1(b).

reported on Form 8883, rather than on Form 8023. For example, the aggregate deemed sales price (ADSP) and the adjusted grossed-up basis (AGUB) are now reported on Form 8883 rather than on Form 8023. The addition of Form 8883 also allows taxpayers to file a complete, timely section 338 election on Form 8023 even if all the information required to be supplied separately on Form 8883 is not available.

Form 8023 is filed with the IRS processing center in Ogden, Utah. Form 8023 is no longer required to be attached to either new target's, old target's, or the purchasing corporation's income tax returns. Form 8883 is filed by old target and by new target. In general, Form 8883 is attached to the return on which the effects of the section 338 deemed sale and purchase of the target's assets are required to be reported.

(j) Summary of I.R.C. Section 338

In summary, I.R.C. section 338 represents the only means of obtaining a step-up in basis in assets of a target following a purchase of the target's stock. The need for a liquidation, as under prior law, has been replaced with an election and deemed sale of assets. These results are achieved in a complex statutory scheme that includes broad delegation of power to the Treasury Department. In at least 16 instances, I.R.C. section 338 authorizes Treasury to write regulations to carry into effect the code provisions.[84] Although the Tax Reform Act of 1986 substantially reduced the desirability of affirmatively making a section 338(g) election, knowledge of the section 338 rules is still important.

§ 7.6 OTHER TAX CONSIDERATIONS

(a) I.R.C. Section 385

In 1969, Congress enacted I.R.C. section 385, which authorized the Secretary to prescribe regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness or part stock and part indebtedness. I.R.C. section 385(b) lists five nonexclusive factors that are to be considered in determining whether an instrument is debt or equity. These factors are:

1. Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
2. Whether there is subordination to or preference over any indebtedness of the corporation;
3. The ratio of debt to equity of the corporation;
4. Whether there is convertibility into the stock of the corporation; and

[84] I.R.C. §§ 338(b)(2), 338(b)(3), 338(b)(5), 338(e)(2)(D), 338(e)(3), 338(g)(1), 338(g)(2), 338(h)(3)(B), 338(h)(4)(B), 338(h)(6)(B), 338(h)(8), 338(h)(9), 338(h)(10)(A), 338(h)(11), 338(h)(15), and 338(i).

5. The relationship between holdings of stock in the corporation and holdings of the interest in question.

In 1980, the Treasury issued proposed and final regulations under I.R.C. section 385, but the regulations were withdrawn in November 1983. The withdrawn regulations set forth the following factors: (1) whether the repayment of the debt is contingent on some event; (2) the debt-to-equity ratio of the lender; (3) whether the interest rate is reasonable; (4) whether the debt holdings are proportionate to the borrower's stock holdings of the lender; (5) whether the instrument is convertible into stock of the lender; and (6) whether interest and principal payments are made timely. Although these regulations were withdrawn, circuit courts have stated that these five factors should be analyzed in determining whether a given relationship is a debtor-creditor relationship or a corporation-shareholder relationship.[85]

Courts have also set forth more detailed lists of factors to be examined in making the debt/equity determination. For example, the Eleventh Circuit listed the following factors:[86]

- The names given to the certificates evidencing the indebtedness;
- The presence or absence of a fixed maturity date of the debt;
- The source of payments on the debt;
- The right to enforce payment of principal and interest;
- Participation in management flowing as a result of the indebtedness;
- The subordination of the debt;
- The intent of the parties;
- "Thin" or adequate capitalization of the corporation;
- The identity of interest between creditor and stockholder;
- The source of interest payments on the indebtedness;
- The ability of the corporation to obtain loans from outside lending institutions;
- The extent to which the advance was used to acquire capital assets; and
- The failure of the debtor to repay on the due date or to seek a postponement.

The Third Circuit listed the following factors:[87]

- The intent of the parties;
- The identity between creditors and shareholders;

[85] *See Sleiman v. Commissioner,* 187 F.3d 1352, 1357 n.9 (11th Cir. 1999); *Selfe v. United States,* 778 F.2d 769, 773 n.9 (11th Cir. 1985).

[86] *See In re Lane,* 742 F.2d 1311, 1314-15 (11th Cir. 1984), *citing Mixon v. United States,* 464 F.2d 394, 407 (5th Cir. 1972).

[87] *Fin Hay Realty Co. v. United States,* 398 F.2d 694, 696 (3d Cir. 1968).

- The extent of participation in management by the holder of the instrument;
- The ability of the corporation to obtain funds from outside sources;
- The "thinness" of the capital structure in relation to debt;
- The risk involved;
- The formal indicia of the arrangement;
- The relative position of the obligees as to other creditors regarding the payment of interest and principal;
- The voting power of the holder of the instrument;
- The provision of a fixed rate of interest;
- A contingency on the obligation to repay;
- The source of the interest payments;
- The presence or absence of a fixed maturity date;
- A provision for redemption by the corporation;
- A provision for redemption at the option of the holder; and
- The timing of the advance with reference to the organization of the corporation.

Although different lists of factors have been developed in the various circuit courts, common themes exist.[88]

These factors are intended as a guide to the court in evaluating whether the parties created a *bona fide* debtor-creditor relationship in a manner comporting with economic reality in which the creditor has a reasonable expectation of repayment.[89] Courts have also stated that the substance and not the form of a transaction controls and that the substance of the transaction will be closely scrutinized, especially if a debtor and creditor are jointly controlled.[90]

(b) Notice 94-47

In 1994, the IRS issued Notice 94-47,[91] which outlined factors to be considered in determining whether an instrument should be treated as debt or equity for federal tax purposes. The Notice states that "characterization of an instrument as debt or equity will depend on the terms of the instrument and all surrounding facts and circumstances," but it also sets forth eight nonexclusive factors to assist the taxpayer in making this determination:

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[88] *See, e.g., Hardman v. Commissioner*, 827 F.2d 1409 (9th Cir. 1987); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986).

[89] *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367 (1973), *acq.*, 1974-2 C.B. 3.

[90] *Laidlaw Transp., Inc. v. Commissioner*, 75 T.C.M. (CCH) 2598 (1998), *citing Road Materials, Inc. v. Commissioner*, 407 F.2d 1121, 1124 (4th Cir. 1969).

[91] 1994-1 C.B. 357.

1. Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
2. Whether the holders of the instruments possess the right to enforce the payment of principal and interest;
3. Whether the rights of the holders of the instruments are subordinate to the rights of general creditors;
4. Whether the instruments give the holders the right to participate in the management of the issuer;
5. Whether the issuer is thinly capitalized;
6. Whether there is an identity between the holders of the instruments and the stockholders of the issuer;
7. The label placed on the instruments by the parties; and
8. Whether the instruments are intended to be treated as debt or equity for nontax purposes.

In the absence of regulations, debt/equity determinations remain a murky area of the tax law, and one that requires careful attention to the facts and circumstances of each case.

§ 7.7 ADMINISTRATIVE EXPENSES

(a) Introduction

As with other business transactions, the administrative and transactional expenses associated with various aspects of bankruptcy can be substantial. Thus, the deductibility or nondeductibility of these expenses is important. The discussion that follows will consider various authorities that address the proper tax treatment of bankruptcy costs directly and will also consider broader authorities that address transactional expenses outside the bankruptcy context.

On December 31, 2003, the IRS and Treasury released final regulations addressing deduction and capitalization of certain expenditures. The discussion below will first address the pre-regulatory authorities and will then address the new regulations.

(b) Preregulatory Authorities

(i) Revenue Ruling 77-204

In Rev. Rul. 77-204,[92] the IRS concluded that all costs associated with the institution and administration of a liquidation of a bankruptcy estate are deductible. Although this ruling deals with a straight liquidation under Chapter VII of the Bankruptcy Act and with a Chapter X reorganization, it should apply to liquida-

[92] 1977-1 C.B. 40.

tions under both Chapter VII and Chapter XI (where a plan of liquidation is approved) of the Bankruptcy Code.

In the ruling, the IRS looked at two situations—a Chapter X reorganization and a liquidation, both under the Bankruptcy Act—and concluded that administrative expenses incurred during the liquidation are deductible.

The IRS concluded that, in the case of a reorganization, the expenses are deductible to the extent that corporations in general are permitted to deduct expenses connected with a reorganization. For tax purposes, the filing of a bankruptcy petition by a corporation did not create a separate tax entity. Rev. Rul. 77-204 develops two categories of administrative expenses:

1. *Otherwise deductible.* The expenses can be deducted to the extent they would have been deducted in general.
2. *Institution and administration.* Administrative expenses are deductible except to the extent that such expenses were incurred in connection with the institution and administration of the case.[93]

The costs associated with the imposition and administration of a bankruptcy case are not deductible, because they are capital expenditures that will benefit the corporation in future years.

(ii) Placid Oil

One of the first major cases to deal with the deduction of administrative expenses in a bankruptcy context was *In re Placid Oil Co.*[94] Placid Oil Co., which operated oil and gas interests, borrowed approximately $1 billion in 1983. When its lenders began foreclosure proceedings in 1986, Placid filed a chapter 11 bankruptcy petition. The company's plan of reorganization was confirmed in 1988. On its tax return, the company deducted the fees it had paid to its lawyers and accountants, and the IRS disallowed the deductions.

Placid Oil argued that, once it had refuted the IRS's proof of claim, the burden of proof was on the IRS to prove that the debtor was not entitled to the administrative expense deductions. The court agreed that in a bankruptcy court, which is different from a tax court, once the debtor provides sufficient evidence to rebut the proof of claim, the burden of proof is on the IRS to show why the administrative expense is not deductible. However, in this case, the court concluded that the debtor had not satisfied its burden regarding its objection to the IRS's claim.

Placid Oil also argued that it did not have any nondeductible reorganization expenses for tax purposes. Placid Oil had not gone through a reorganization under I.R.C. section 368(a). The debtor had used chapter 11 to provide leverage in negotiating with its creditors. As a result, the expenses were ordinary and necessary business expenses.

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[93] *See Chicago, Milwaukee, St. Paul & Pacific R.R. Co. v. United States,* 404 F.2d 960 (Ct. Cl. 1968); *Denver & Rio Grande Western Railroad Co. v. Commissioner*, 38 T.C. 557 (1962), *acq.* 1963-2 .B. 4; *Bush Terminal Buildings Co. v. Commissioner,* 7 T.C. 793 (1946), *acq.* 1947-2 C.B. 1.

[94] *In re Placid Oil Co.,* 140 B.R. 122 (Bankr. N.D. Tex. 1990), *rev'd*, 988 F.2d 554 (5th Cir. 1993).

The court determined that, under Placid Oil's plan, a substantial percentage of its assets were sold, operations were downscaled, and its debts were reduced. Thus, although the bankruptcy court agreed that Placid Oil did not qualify for any of the reorganizations listed in I.R.C. section 368(a), it found no authority to conclude that the list in section 368(a) was an exhaustive list of all possible types of reorganizations for purposes of determining the deductibility of administrative expenses. The court stated, "Through the bankruptcy, Placid restructured its debt as to amount and terms of payment. Furthermore, Placid's bankruptcy reorganization not only insured Placid's survival but maintained the reorganization value of the corporation for the creditors and the owners." The court denied the deduction of any of the administrative expenses.

On appeal, the Fifth Circuit reversed the bankruptcy court's decision in *Placid Oil*.[95] The Fifth Circuit held that a taxpayer in bankruptcy who challenges a federal tax claim arising from the disallowance of deductions does not have the burden of proof on its entitlement to the deductions. The court ordered the bankruptcy court to differentiate between the company's capital expenses and its nondeductible fees and expenses.

The IRS has indicated that it will not follow the Fifth Circuit decision, on the grounds that it conflicts with the general rule that the taxpayer bears the ultimate burden of proof for deductions, and with the Fourth Circuit decision in *IRS v. Levy (In re Landbank Equity Corp.)*.[96]

(iii) Private Letter Ruling 9204001

In Private Letter Ruling 9204001,[97] the IRS was asked by a taxpayer to rule on the deductibility of all expenses associated with a bankruptcy involving substantial tort claims. The taxpayer argued that, because the dominant focus and work on the case related to defending those with business-related tort claims, all expenses associated with the bankruptcy should be deductible. The taxpayer invoked the "origin of claim" doctrine, which determines deductibility from the context in which the expenses were incurred. Because costs of defending against tort claims are generally deductible, all administrative costs associated with the chapter 11 case should be deductible.

The IRS ruled that the "dominant aspect" of the bankruptcy may not be used to determine the deductibility of all bankruptcy-related costs. The IRS stipulated that the "otherwise deductible" standard under Rev. Rul. 77-204 is applicable here, rather than the dominant aspect doctrine.

(iv) **INDOPCO** *and Related Authorities*

In *INDOPCO, Inc. v. Commissioner*,[98] the Supreme Court held that an expense will not be deductible if the taxpayer expects to realize a benefit from the expense in a year subsequent to the year in which the expense was incurred.

[95] 988 F.2d 554 (5th Cir. 1993).
[96] 973 F.2d 265 (4th Cir. 1992). *See* nonacquiescence in *Placid Oil*, 1995-16 I.R.B. 4.
[97] (May 13, 1991).
[98] 503 U.S. 79 (1992).

This holding would support the doctrine adopted in Rev. Rul. 77-204, which would allow the deduction of an administrative expense if it would have been deductible except for the filing of the chapter 11 petition. The Supreme Court rejected the argument some commentators have advanced from *Commissioner v. Lincoln Savings & Loan Association,*[99] that in order for an expense to be capitalized, the expense must be incurred either to create or enhance a separate or distinct asset.

In *A.E. Staley Manufacturing Co. v. Commissioner,*[100] the Court of Appeals for the Seventh Circuit, reversing and remanding a decision of the Tax Court, held that a corporation was entitled to deduct costs relating to the defense of its business and its corporate policy against a hostile takeover.

In *Staley*, the corporation incurred investment bankers' fees in defending against a takeover that the board viewed as hostile, but ultimately approved due to a lack of alternative transactions. The Tax Court took the view that the transaction giving rise to the investment bankers' fees was an acquisition and thus a change in corporate structure. The Tax Court relied on the Supreme Court's decision in *INDOPCO,* which held that costs incurred to facilitate a friendly acquisition are capital expenditures and, therefore, not immediately deductible. Accordingly, the Tax Court held that expenses arising from the investment bankers' fees were in connection with a change in ownership and must be capitalized.

The Seventh Circuit, however, focused its analysis on whether the investment bankers' fees were more properly viewed as costs associated with defending a business or as costs associated with facilitating a capital transaction. The court reasoned that the bulk of the investment bankers' time was spent attempting to frustrate the occurrence of a merger and to evaluate alternative transactions, rather than facilitating the acquisition. The court noted that the *INDOPCO* decision merely reaffirmed a well-settled law that costs incurred to facilitate a capital transaction are capital costs. *INDOPCO,* the Court of Appeals pointed out, did not change the law with respect to costs incurred to defend a business. Such defense costs seek to preserve the status quo, not to produce future benefits.

Accordingly, Seventh Circuit held that costs incurred by the taxpayer to defend its business were deductible under I.R.C. section 162(a). Furthermore, costs incurred to evaluate alternative transactions, which were subsequently abandoned, were deductible under I.R.C. section 165 as abandonment expenses. The court did, however, state that the portion of investment banker fees incurred to facilitate the acquisition were to be capitalized (e.g., costs incurred to value the taxpayer's stock).

Citing *Staley,* the United States Bankruptcy Court held in *Hillsborough Holdings Corporation v. United States*[101] that the tax treatment of costs incurred by a taxpayer in bankruptcy proceedings for professional services depends on the nature of the services performed by professionals. To determine the nature of

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[99] 403 U.S. 345 (1971).
[100] 119 F.3d 482 (7th Cir. 1997), *rev'g* 105 T.C. 166 (1995).
[101] 1999 Bankr. LEXIS 445 (M.D. Fla. 1999).

the services performed, all the facts of the case must be considered to determine the context of the expenditures and the types of services performed. In *Hillsborough,* the court reasoned that the restructuring of a corporation in bankruptcy was an extraordinary event outside of the corporation's usual trade or business. In addition, the restructuring allows the corporation to continue to exist as a viable business. Thus, the court held that certain expenses incurred by the taxpayer were not properly deductible under section 162(a), including professional fees incurred for services rendered in connection with the administration of the taxpayer's bankruptcy proceedings and for services rendered to various creditor committees. The court did, however, allow the taxpayer a deduction for certain expenses not directly related to the bankruptcy proceedings, including professional fees incurred for services rendered to the taxpayer in defending against asbestos-related personal injury claims and for services rendered in connection with the taxpayer's failed attempt to obtain financing under a line of credit arrangement.

In *Norwest Corp. v. Commissioner,*[102] the Tax Court held that officer's salaries and legal fees incurred by a target company in a friendly acquisition had to be capitalized because the costs were sufficiently related to an event that produced a significant long-term benefit. In *Norwest,* the taxpayer was a target company in a friendly acquisition. A portion of the taxpayer's officers' salaries and certain legal fees were attributed to the acquisition. The taxpayer argued that (1) the officers' salaries were ordinary and necessary business expenses and, therefore, not capitalizable as part of the acquisition because the officers' work on the transaction was tangential to their ordinary duties, and (2) the legal fees were currently deductible because they were primarily for investigatory and due diligence services related to the expansion of its business. The taxpayer relied on the outcome in *Briarcliff Candy Corp. v. Commissioner*[103] and *NCNB Corp. v. United States,*[104] which allowed a deduction for investigation and due diligence costs incurred incident to the expansion of an existing business.

Relying on *INDOPCO,* the IRS argued, and the Tax Court agreed, that all of the costs at issue had to be capitalized because the transaction ". . . involved a friendly acquisition from which the parties thereto anticipated significant long-term benefits for the acquired entity." The Tax Court claimed that the decisions in *Briarcliff* and its progeny have been displaced by *INDOPCO*. On appeal, the Eighth Circuit allowed deductions for costs incurred before the taxpayers reached a final decision about the acquisition.[105]

In *Dana Corp. v. United States,*[106] the Court of Appeals for the Federal Circuit held that a retainer fee paid to a law firm was nondeductible because the retainer fee was ultimately credited to the cost of legal services incurred in an acquisition. The taxpayer in *Dana* had a 16-year history of paying an annual

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[102] 112 T.C. 89 (1999), *rev'd in part aff'd in part, Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000).

[103] 475 F.2d 775 (2d Cir. 1973), *rev'g and remanding* 31 T.C.M. (CCH) 171 (1972).

[104] 684 F.2d 285 (4th Cir. 1982).

[105] *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874, 889 (8th Cir. 2000).

[106] 174 F.3d 1344 (Fed. Cir. 1999).

retainer fee to a law firm with expertise in corporate takeovers. Dana paid the retainer fee to preclude the law firm from representing competitors of Dana in takeover situations and to guarantee the availability of the law firm's services. The retainer fee was nonrefundable but could be used as a credit to offset any legal fees incurred during the corresponding year. During the year in question, the retainer fee was credited against legal fees associated with an acquisition of a target company.

In Rev. Rul. 99-23,[107] the IRS outlined its position on the types of costs incurred by a taxpayer in an acquisition of a target's assets that it considers to be amortizable start-up expenditures under I.R.C. section 195. The ruling outlines the IRS's position in three independent fact patterns and in general concludes that: (1) expenditures incurred in the course of a general search for, or investigation of, an active trade or business to determine *whether* to enter a new business and *which* new business to enter are investigatory costs eligible for amortization under I.R.C. section 195, and (2) expenditures incurred in an attempt to acquire a specific business do not qualify as start-up expenditures because they are acquisition costs subject to the capitalization rules of I.R.C. section 263.

(v) Abandoned Plans

It might be argued under *INDOPCO* that costs associated with abandoned plans are deductible, because no benefit will be realized from abandoned plans. This interpretation was often made prior to *INDOPCO.* For example, in Rev. Rul. 73-580,[108] the IRS ruled that amounts paid to employees with respect to plans for mergers or acquisitions are deductible as losses under I.R.C. section 165 in the year of abandonment. The purpose of the ruling was to clarify that costs of in-house employees are treated like any other expense when determining whether such expenses are deductible.

If administrative costs associated with abandoned plans are deductible, a critical question that must be addressed is what constitutes the abandonment of a plan as opposed to the modification of a plan. The Tax Court's decision in *Sibley, Lindsay, & Curr Co. v. Commissioner*[109] gives some insight. In that case, a corporate taxpayer retained the services of an investment banking firm to analyze the method available to change its capital structure. The investment bankers developed three restructuring plans but only one was implemented. Sibley deducted the costs that it had allocated to the two plans that were not adopted and capitalized the costs related to the adopted plan. The court held that because the plans were not alternatives but were separate and distinct suggestions for revisions of the capital structure, the expenses allocated to the abandoned proposals were properly deductible in the year it was determined which of the proposals would be adopted. The court noted that new proposals were offered only as each previous proposal was rejected. This standard developed in *Sibley*

[107] 1999-1 C.B. 998.
[108] 1973-2 C.B. 86.
[109] 15 T.C. 106 (1950), *acq*. 1951-1 C.B. 3.

was applied in *Tobacco Products Export Corp. v. Commissioner,*[110] in which the court examined whether the plans were separate and distinct.

But, if proposals are alternatives, only one of which can be completed, no abandonment loss will be allowed unless the entire transaction is abandoned.[111]

(c) Final *INDOPCO* Regulations

On December 31, 2003, the IRS and Treasury released final regulations (T.D. 9107) addressing deduction and capitalization of certain expenditures. These regulations address general deduction/capitalization issues as well as deduction/capitalization rules that arise in taxable and tax-free reorganizations.

In general, these regulations require capitalization of amounts that *facilitate* enumerated transactions (whether taxable or tax-free), including (1) a taxpayer's acquisition of assets that constitute a trade or business, (2) a taxpayer's acquisition of an ownership interest that gives the acquirer a greater than 50% interest in a business entity, (3) an acquisition by another of an interest in a taxpayer (but not via redemption), (4) a recapitalization, a reorganization, or a section 355 distribution, (5) a section 351 or a section 721 transfer, (6) a formation of a corporation, (7) an acquisition of capital, (8) an issuance of stock, (9) a borrowing, or (10) a writing of an option.

Facilitate, for this purpose means "paid in the process of investigating or otherwise pursuing" the transaction. The regulations indicate that this is a facts and circumstances inquiry, that the fact that an amount would/would not have been paid but for the transaction is not determinative, and that amounts paid to determine value are included.

The regulations also enumerate certain costs that do not *facilitate*. Thus, (1) amounts paid to facilitate a borrowing will not be treated as facilitating another transaction, (2) amounts paid to facilitate a sale of assets will not be treated as facilitating another transaction (e.g., amounts paid to facilitate a divestiture prior to a merger are not costs that facilitate the merger). The regulations also treat the following as non-facilitative: mandatory stock distributions, stock issuance costs of open-ended regulated investment companies, integration costs, *routine* stock registrar and transfer agent fees (e.g., proxy statements requesting approval of an acquisition do facilitate), termination of earlier agreements, employee compensation (can elect to capitalize), and overhead and de minimis costs (not over $5,000) (can elect to capitalize).

With regard to costs associated with terminated/abandoned transactions, the regulations provide that in general, amounts paid to facilitate a transaction are treated as facilitating a second transaction only if the transactions are mutually exclusive and the first transaction is abandoned to enable the taxpayer to

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[110] 18 T.C. 1100 (1952).

[111] *Larsen v. Commissioner,* 66 T.C. 478, 483 (1976), acq. 1977-2 C.B. 1; Private Letter Ruling 9402004 (Sept. 10, 1993) ("Taxpayer was not pursuing seven separate and distinct plans all of which could have been completed. Rather, finding seven potential buyers was part of the effort to accomplish a single transaction: the sale of Taxpayer. . . . Accordingly, Taxpayer is not entitled to claim a loss under section 165 of the Code."). The final *INDOPCO* regulations, discussed below, contain a similar rule. *See* Treas. Reg. § 1.263(a)-5(l) Ex. 13.

engage in the second transaction. Also, amounts paid to terminate an earlier agreement will be treated as facilitating a later transaction only if the two transactions are mutually exclusive and the agreement is terminated to enable the taxpayer to engage in the second transaction.

In general, the regulations treat most costs incurred to institute or administer a bankruptcy proceeding as costs that facilitate a bankruptcy reorganization. Thus, costs of the debtor to institute or administer a Chapter 11 proceeding generally must be capitalized. On the other hand, costs to operate the debtor's business during a Chapter 11 proceeding (including the types of costs described in Revenue Ruling 77-204, discussed above), do not facilitate the bankruptcy and are treated in the same manner as such costs would have been treated had the bankruptcy proceeding not been instituted. The regulations also provide that capitalization is not required for (1) amounts paid by a taxpayer to defend against an involuntary bankruptcy proceeding and (2) amounts paid to formulate, analyze, contest, or obtain approval of the portion of a plan of reorganization under Chapter 11 that resolves a taxpayer's tort liability, provided the amount would have been treated in a non-bankruptcy context as an ordinary and necessary business expense under I.R.C. section 162.

Finally, the regulations set forth special rules for certain costs of *covered* transactions that are not *inherently facilitative* and that occur before a specified time. Subject to the exception for *inherently facilitative amounts,* discussed below, amounts spent on *covered* transactions do *not* facilitate if they occur before earlier of (1) the issuance of a letter of intent and (2) the authorization or approval of material terms by the board of directors or appropriate governing officials (or if no one needs to authorize or approve, by the date of a binding written contract).

For this purpose, *covered* transactions include, (1) *taxable* acquisitions by a taxpayer of assets that are a trade or business, (2) *taxable* acquisitions of a greater-than-50-percent interest where the taxpayer is either the acquirer or the target, or (3) an "A", "B", "C", or acquisitive "D" reorganization, where the taxpayer is either the acquirer or the target. Type "G" reorganizations are not referenced in this list.

With regard to *inherently facilitative* amounts, the regulations provide that these are amounts paid for *covered* transactions that *facilitate* the transaction, even if they are paid before the letter of intent/authorization date. These include amounts paid for (1) an appraisal or a fairness opinion, (2) structuring or tax advice, (3) preparing and reviewing documents, (4) regulatory approval, (5) shareholder approval, and (6) conveying property (transfer taxes, title registration).

Once costs have been capitalized pursuant to the rules set forth above, the new regulations address their subsequent treatment in limited cases, but defer addressing that treatment in many others. For example, for costs incurred in taxable acquisitive transactions by an acquirer, the regulations require those costs to be added to the basis of the acquired assets or stock. And, for costs incurred in a borrowing, the regulations generally provide for amortization of the costs over the term of the debt. On the other hand the regulations reserve on (among other things) the proper subsequent treatment of target's costs in a taxable stock acquisition, stock issuance costs, and tax-free acquisitive transaction costs.

In general, the final regulations apply to amounts paid or incurred on or after January 5, 2004.

§ 7.8 OTHER ADMINISTRATIVE ISSUES

(a) Responsibility for Filing Corporate Tax Returns

Filing a petition under title 11 does not generally affect the filing of a corporation's income tax returns. That is, a separate taxable entity is not created as a result of the corporation's commencement of title 11 proceedings.[112] The return must be filed even though the corporate charter has been revoked.[113] I.R.C. section 6012(b)(3) imposes a tax return filing obligation on trustees in bankruptcy who have possession of or hold title to "all or substantially all the property or business of a corporation, whether or not such property or business is being operated. . . ." If the trustee possesses only a small part of the property of a corporation, then the trustee is not required to file an income tax return.[114]

Treas. Reg. section 1.6012-3(b)(4) requires a fiduciary that has possession of all or substantially all of a corporation's assets to file corporate tax returns, regardless of whether the trust is an operating trust or a liquidating trust.[115] Before the Supreme Court resolved the issue, some courts distinguished between an operating and a liquidating trustee.[116] In *Holywell Corp. v. Smith,*[117] the Supreme Court agreed with the IRS on the matter and required a liquidating trustee to file income tax returns and pay tax.

A trustee may be obligated to file tax returns and pay tax for pre-petition periods. The IRS may impose late filing penalties and negligence penalties against the corporation or the trustee if the trustee files a late or inaccurate return.[118] The *In re Hudson Oil Co.*[119] court held that the trustee must file the corporate return for the year that ended just prior to the filing of the petition. The court disagreed with the trustee's reliance on Section 1106(a)(6) of the Bankruptcy Code. Section 1106(a)(6) provides that the trustee or debtor-in-possession must file a tax return, without personal liability, for any year in which the debtor has not filed a return. The return must include such information as may be required by the taxing authority in light of the condition of the debtor's books and records and the availability of such information. The court held that section 1106(a)(6) did not excuse the trustee from filing a tax return.[120]

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[112] I.R.C. § 1399.

[113] *See* Rev. Rul. 84-170, 1984-2 C.B. 245.

[114] Treas. Reg. § 1.6012-3(b)(4) –(5).

[115] *See also* Rev. Rul. 84-170, 1984-2 C.B. 245 ("[I]t is clear that a receiver or trustee must make a return for a corporation in the process of liquidation even though business is no longer being conducted.")

[116] *See, e.g., In re Holywell Corp.*, 911 F.2d 1539 (11th Cir. 1990).

[117] 503 U.S. 47 (1992).

[118] *Nicholas v. United States,* 384 U.S. 678 (1966); *In re Hudson Oil Co.*, 91 B.R. 932 (Bankr. D. Kan. 1988).

[119] 91 B.R. 932 (Bankr. D. Kan. 1988).

[120] *But see* Private Letter Ruling 850938 (Nov. 30 1984) (ruling trustee is not obligated to file returns for that were due prior to the trustee's appointment).

Rev. Rul. 84-123[121] does, however, provide that a return need not be filed for a corporation with neither assets nor income. Even though a return is not filed, that period for which a return normally would be required will constitute a taxable year for the carryover of any net operating loss. Rev. Proc. 84-59[122] states that, to obtain relief from filing, the trustee, receiver, or assignee should file a request with the proper District Director, stating:

- Name, address, and employer identification number of the corporation;
- Date notice of appointment as trustee, receiver, or assignee was filed with the IRS;
- The reason why relief is needed. The request should contain the following: "I hereby request relief from filing federal income tax returns for tax year(s) ending ____ for the above named corporation and declare under penalties of perjury that to the best of my knowledge and belief the information contained herein is correct."[123]

The District Director will send notification within 90 days whether the request is granted or denied. See § 4.2(c) for a discussion of the responsibility for filing individual returns and § 3.2(c) for filing partnership returns.

In the case of a chapter 7 petition, section 704 of the Bankruptcy Code provides that the trustee must file tax returns where the trustee is authorized to operate the business. Sections 346, 728, 1146, and 1231 of the Bankruptcy Code deal with the responsibilities of the trustee or debtor-in-possession to file state and local tax returns. This responsibility is discussed in Chapter 10.

(b) Liquidating Trusts

Frequently a bankruptcy reorganization plan will require that assets be sold and the proceeds distributed to the unsecured creditors. Not surprisingly, in many such cases the assets may not be readily saleable, except over an extended period of time. In such cases, the assets may be placed in a so-called liquidating trust to be sold over time. In general, the beneficiaries of a liquidating trust are the unsecured creditors. The failing company's transfer of the assets to the trust discharges its liability to the creditors and the company retains no interest in the assets. The trustee, who is usually a bank, has limited powers, and is charged with selling the assets and distributing the proceeds to the creditors.

The primary tax issue raised by such an arrangement is whether the trust will be eligible for taxation as a liquidating trust (rather than as an association), with the incidence of taxation falling solely on the creditor-beneficiaries.

In general, a trust that qualifies as a liquidating trust is treated as a grantor trust under I.R.C. sections 671–677, whose grantors are the creditor/beneficiaries of the trust. Treas. Reg. section 301.7701-4(d) defines a liquidating trust as follows:

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[121] 1984-2 C.B. 244.

[122] 1984-2 C.B. 504.

[123] *Id.*

> Certain organizations which are commonly known as liquidating trusts are treated as trusts for purposes of the Internal Revenue Code. An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for purposes of the Internal Revenue Code because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust. Bondholders' protective committees, voting trusts, and other agencies formed to protect the interests of security holders during insolvency, bankruptcy, or corporate reorganization proceedings are analogous to liquidating trusts but if subsequently utilized to further the control or profitable operation of a going business on a permanent continuing basis, they will lose their classification as trusts for purposes of the Internal Revenue Code.[124]

In Rev. Proc. 94-45,[125] the IRS specified conditions under which it will consider issuing advance rulings classifying entities created under chapter 11 bankruptcy plans as liquidating trusts under Treas. Reg. section 301.7701-4(d). The Revenue Procedure also outlines income reporting requirements for liquidating trusts and provides a checklist that must accompany all ruling requests. The Revenue Procedure contains the following requirements:

- The trust must be created pursuant to a confirmed plan under chapter 11 of the Bankruptcy Code for the primary purpose of liquidating the assets transferred to it, and with no objective to continue or engage in the conduct of a trade or business, except to the extent reasonably necessary to, and consistent with, the liquidating purpose of the trust.
- The plan and disclosure statement must explain how the bankruptcy estate will treat the transfer of its assets to the trust for federal income tax-purposes. A transfer to a liquidating trust for the benefit of creditors must be treated for all purposes of the I.R.C. as a transfer of assets to the beneficiary creditors followed by a transfer by the beneficiary-creditors to the trust. The ruling request must explain whether the debtor or the bankruptcy estate will incur any tax liability from the transfer and, if so, how that liability will be paid.[126]
- The plan, disclosure statement, and any separate trust instrument must provide that the beneficiaries of the trust will be treated as the grantors and deemed owners of the trust. The trust instrument (which may be the plan if there is no separate trust instrument) must require that the trustee file returns for the trust as a grantor trust pursuant to Treas. Reg. section 1.671-4(a).

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[124] *See also* Rev. Proc. 82-58, 1982-2 C.B. 847, *amplified by* Rev. Proc. 91-15, 1991-1 C.B. 484 (addressing advance rulings on status of liquidating trusts), *and modified by* Rev. Proc. 94-45, 1994-2 C.B. 685.

[125] 1994-2 C.B. 684.

[126] This requirement should obviate any possible problems that might otherwise arise under the 1992 Supreme Court case of *Holywell Corp. v. Smith*, discussed *supra* at § 7.8(a).

- The plan, disclosure statement, and any separate trust instrument must provide for consistent valuations of the transferred property by the trustee and the creditors (or equity interest holders), and those valuations must be used for all federal income tax purposes.
- Whether or not a reserve is established for disputed claims, all of the trust's income must be treated as subject to tax on a current basis, and the ruling request must explain, in accordance with the plan, how the trust's taxable income will be allocated and who will be responsible for payment of any tax due.[127]
- The trust instrument must contain a fixed or determinable termination date that is generally not more than five years from the date of creation of the trust and that is reasonable based on all the facts and circumstances. If warranted by the facts and circumstances, provided for in the plan and trust instrument, and subject to the approval of the bankruptcy court with jurisdiction over the case upon a finding that the extension is necessary to the liquidating purpose of the trust, the term of the trust may be extended for a finite term based on its particular facts and circumstances. The trust instrument must require that each extension be approved by the court within six months of the beginning of the extended term.
- If the trust is to hold any operating assets of a going business, a partnership interest in a partnership that holds operating assets, or 50 percent or more of the stock of a corporation with operating assets, the ruling request must explain why it is necessary to retain these assets.
- If the trust is to receive transfers of listed stocks or securities or other readily marketable assets, the ruling request must explain the necessity for doing so. The trust is not permitted to receive or retain cash or cash equivalents in excess of a reasonable amount to meet claims and contingent liabilities (including disputed claims) or to maintain the value of the assets during liquidation.
- The investment powers of the trustee, other than those reasonably necessary to maintain the value of the assets and to further the liquidating purpose of the trust, must be limited to powers to invest in demand and time deposits, such as short-term certificates of deposit, in banks or other savings institutions, or other temporary, liquid investments, such as Treasury bills.
- The trust must be required to distribute at least annually to the beneficiaries its net income plus all net proceeds from the sale of assets, except that the trust may retain an amount of net proceeds or net income reasonably necessary to maintain the value of its assets or to meet claims and contingent liabilities (including disputed claims).
- The ruling request must contain representations that the trustee will make continuing efforts to dispose of the trust assets, make timely distributions, and not unduly prolong the duration of the trust.

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[127] *See supra*, § 7.8(a).

CHAPTER EIGHT

State and Local Taxes

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§ 8.1 INTRODUCTION

The Bankruptcy Reform Act of 1978, as originally drafted in H. R. 8200, contained many tax provisions, including the handling of income from debt discharge, the use of net operating loss (NOL) carryforwards, termination of taxable years of the estate, and the responsibility for filing income tax returns. In the early stages of the revision of the bankruptcy law, it appeared to be acceptable to the House Committee on Ways and Means to leave the federal tax provisions in the bankruptcy bill. However, with a change in the chairmanship of the committee, the federal tax provisions were removed from the bill by inserting "state and local" before the word "tax." It was contemplated that the federal tax laws would conform to the state and local tax laws or, if changes were made in the federal laws, the Judiciary Committees of both the House and the Senate

would amend the state and local provisions of the Bankruptcy Code so that the state and local tax rules would conform with the federal. After a delay of over 2 years, the House and Senate passed the bill on December 13, 1980, and the president signed the Bankruptcy Tax Act of 1980 on December 24, 1980. Congress has not passed any bill that makes any attempt to conform the state and local tax laws with those contained in the Bankruptcy Tax Act of 1980.

Because the Bankruptcy Code only covers state and local taxes for an entity in title 11, the impact of debt discharge, preservation of net operating losses, and so on, in an out-of-court workout will be governed by state and local tax laws. Thus, although the tax impact of debt discharge by an insolvent taxpayer in an out-of-court settlement or by a debtor in bankruptcy will be the same for federal tax purposes, the tax impact may differ significantly for state and local tax purposes.

The objectives of this chapter are to discuss some of the provisions of the Bankruptcy Code that impact state and local tax issues[1] and include proposed modifications to the Bankruptcy Code to eliminate the differences between federal and state taxes for individuals in bankruptcy.

§ 8.2 INCOME FROM DEBT DISCHARGE

Section 346(j)(1) of the Bankruptcy Code provides that income is not realized by the estate, the debtor, or a successor to the debtor by reason of the forgiveness or cancellation of debt in a title 11 case.

(a) Disallowance of Related Deductions

Section 346(j)(2) of the Bankruptcy Code provides that a deduction with respect to a canceled liability is not allowed for the year in which the debt was canceled or for future years. Thus, for example, if a liability is incurred to purchase a building and part of that debt was canceled, deductions for depreciation to the extent that the debt was canceled will be disallowed. This provision would also apply to preclude the taxpayer from deducting all or part of a capital loss subsequently realized on the disposal of a capital asset that was pledged as security for a debt incurred at the time the asset was purchased. For federal tax purposes, there is no provision in the Internal Revenue Code that would disallow deductions when the related liability is canceled.

(b) Tax Attribute Reduction

As noted above, section 346(j)(1) of the Bankruptcy Code provides that, for state and local tax purposes, gain from debt forgiveness or discharge is not recognized by the estate, debtor, or successor to the debtor. However, as is true for the cancellation of debt for federal tax purposes, tax attributes must be reduced. Section 346(j) provides that two attributes are to be reduced for state and local tax

[1] H. Rep. No. 595, 95th Cong., 1st Sess. 334–337 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 44–47 (1978).

purposes, and five attributes are to be reduced for federal tax purposes. The two attributes to be reduced for state and local tax purposes are:

1. Net operating loss carryover;
2. Basis of debtor's property but not in excess of the liabilities immediately after discharge.

(i) Net Operating Loss Carryovers

Section 346(j)(3) of the Bankruptcy Code indicates that net operating loss (NOL) carryover is the first attribute to be reduced, but does not indicate the time at which the deduction should be made. It is presumed that the deduction would be made at the time of the discharge or forgiveness. Thus, none of the net operating losses for the year in which the discharge occurs would be reduced unless (1) there is a closing of the books as of the day the petition is filed, or (2) the taxpayer interprets this section to mean that the total net operating losses for the year should be prorated, based on time, between those losses incurred prior to the filing of the petition and those incurred after the filing of the petition. For federal tax purposes, the deductions take place after the computation of the tax loss for the year in which the discharge occurs. As a result of this timing difference, the tax impact of a discharge for state and federal purposes may differ significantly; the net operating loss in the year the petition is filed is often very large.

Section 346(j)(4)(A) of the Bankruptcy Code provides that the net operating loss is not reduced to the extent that canceled debt consists of items of a deductible nature that were not deducted by the debtor. For example, if the debtor is a cash-basis taxpayer, the cancellation of a liability with no tax basis would not require the reduction of either net operating loss or basis. A similar provision applies in the case of federal income taxes.

(ii) Basis Reduction

The only other tax attribute that must be reduced is basis in property. No distinction is made between depreciable or nondepreciable property. Also, because no timing difference is provided in section 346 of the Bankruptcy Code, it will be presumed that the basis will be reduced as of the date the discharge occurs. For federal tax purposes, it takes place as of the first day of the taxable year after the year in which the discharge occurs.

The debtor may elect to include the gain from the discharge of debt in income rather than reduce the basis of property under section 346(j)(6) of the Bankruptcy Code. For example, a chapter 11 debtor that is in a very low tax bracket for state income tax purposes may prefer to report the income and then be able to deduct depreciation expenses in future years when a higher tax bracket would apply. An individual may have itemized deductions that would offset any gain from the discharge of debt in the current period. Thus, the taxpayer might, under these conditions, prefer to report the gain from debt discharge rather than reduce basis.

Section 346(j)(6) of the Bankruptcy Code does not indicate the order in which basis will be reduced. It might be assumed that the order for federal income tax purposes could be used here, as follows:

- Property (real and personal, other than inventory and receivables) that was pledged at the time of purchase as security interest for debt that was discharged;
- Property (real and personal, other than inventory and receivables) that was subsequently pledged as security interest for debt that was discharged;
- Property other than inventory and accounts and notes receivable;
- Inventory and accounts and notes receivable.

However, when no order for the reduction is specified, it might seem logical to reduce all property proportionally. The net impact of this approach for state and local tax purposes could be significantly different from that for federal purposes. This would be true even in states that have elected to follow the Internal Revenue Code.

There is no provision for the debtor to elect to first reduce depreciable property and then reduce tax attributes; there is such a provision for federal tax purposes.

(c) Stock for Debt

Section 346(j)(7) of the Bankruptcy Code provides that no income from debt forgiveness or discharge is recognized when an equity security is issued in satisfaction of its debt. Section 101(15) of the Bankruptcy Code defines an equity security as a "share in a corporation, whether or not transferable or denominated 'stock' or similar security." It also includes a warrant or right to purchase, sell, or subscribe to a share or security, but does not include the right to convert. A security, as defined in section 101(15), also includes an interest of a limited partner in a limited partnership. However, section 346(j)(7) excludes the interest of a limited partner from the exchange of an equity security for debt rules. This definition of equity security does not specifically mention preferred stock but, because this definition is so broad, it is presumed that it applies to preferred stock.

Since the passage of the Bankruptcy Tax Act of 1980, several restrictions have been placed on the exchange of stock for debt. It appears that most of these restrictions would not apply for state and local tax purposes, such as the use of disqualified stock (redeemable stock) and the IRS's attempts to define the meaning of nominal or token stock.

Section 346(j)(7) of the Bankruptcy Code provides that no income will be recognized from debt discharge to the extent that a shareholder contributed debt of the corporation to its capital. A similar rule applies for a contribution of debt to capital for federal tax purposes.

There is no specific provision in section 346 of the Bankruptcy Code for the exchange of general partnership interest for debt. Limited partnership interests

are specifically excluded, as noted above. Some practitioners argue that an exchange of partnership interest (either general or limited) for debt should not result in income from debt discharge for federal tax purposes.

(i) Limitations

Section 346(j)(7) of the Bankruptcy Code provides that the nonrecognition of income from debt discharge, on the exchange of stock for debt or on the contribution of debt, only applies to the extent that the indebtedness did not consist of items of a deductible nature. If the issuance of such equity security has the same consequences under state or local income tax as a cash payment to the creditor in an amount equal to the fair market value of the security, the exception will apply to the lessor of the extent that the issuance has the same consequence or the extent of the fair market value of the equity security.

For example, there would be no reduction of tax attributes for a cash-basis taxpayer. However, if the taxpayer is on the accrual basis and issues stock with a fair market value of $1,000 to satisfy accrued interest expense in the amount of $1,000, no reduction of tax attributes would be required. If the value of the stock was only $600, then tax attributes would be reduced by $400. The only tax attributes that will be reduced for state and local tax purposes are net operating loss carryforwards and basis of property.

(ii) Parent's Stock

Section 346(j)(7) of the Bankruptcy Code does not state whether the stock-for-debt exception would apply to a transfer of the stock of the parent to satisfy a debt of a subsidiary. The legislative history suggests that the use of a parent's stock should be allowed, that is, the debtor should be treated "as if it had originally issued stock instead of debt." Because an exchange of a parent's stock for stock of the subsidiary would not be subject to income from debt discharge, it should follow that stock issued for debt that is considered as stock would not result in income from debt discharge. However, there is still some question as to the extent to which a parent's stock may be used to cancel a subsidiary's debt. In cases where the courts have substantially consolidated a parent and its subsidiaries, there should not be any income from debt discharge.

§ 8.3 NET OPERATING LOSS CARRYBACK AND CARRYOVER

(a) Introduction

The extent to which the Bankruptcy Code will apply to a carryback or carryover of tax attributes in a reorganization is questionable. If the Bankruptcy Code is silent on a tax issue, the state and local tax laws should be applicable.

(b) State Laws

Many states and local taxing authorities have tax laws that conform to the provisions of the Internal Revenue Code. State and local conformity can mean complete conformity or just the use of federal taxable income as the starting point for the

determination of the state or local tax liability. Other states and local taxing authorities have their own laws that specify how tax liability is to be determined.

With an increase in the number of very large bankruptcies involving many legal entities, the problems associated with state and local taxes have increased. Often, a plan provides for the reduction of the number of entities, but, for federal tax purposes, the reduction alone does not prevent the net operating losses from surviving. However, for state and local tax purposes the survival of the net operating losses may be less certain. Careful planning is therefore needed to preserve as much of the net operating loss as possible.

If the state and local tax laws follow the federal tax attribute carryover under I.R.C. section 381, the net operating losses may survive. Some states and localities may adopt the federal law with restrictions. One such restriction might be that, in order to carry forward the net operating losses in a reorganization from a subsidiary that was merged into the surviving entity, the subsidiary must have been subject to state and local taxes in the period from which the loss arose.

Some states, while not directly incorporating the provisions of I.R.C. section 381, indirectly provide for the adoption of the federal laws by using the federal taxable income, after net operating losses, as the starting point for determining state and local taxable income.[2]

(i) Carryback and Carryforward

Approximately 18 states have conformed generally to the federal rule regarding carrybacks and carryforwards. Most of these states also require that the election to forgo a carryback applies as well for state and local tax purposes. About 18 states allow carryforwards only, and approximately 16 states limit the carryforward period to less than 15 years.[3] During the budget problems faced by state and local governments, some states have temporarily suspended the utilization of net operating loss carryforwards. Some states may also limit the use of net operating losses where the entity was not subject to a state or local tax in the year when the loss occurred.

(ii) Consolidated Groups

The treatment of net operating losses for state and local tax purposes may differ from that for federal taxes for consolidated groups, depending on whether the state allows or requires a consolidated, combined, nexus combined, or separate company filing option. For example, in California, members of a unitary group filing a combined report may combine taxable income and losses in the current year. However, the members of the group must determine the net operating loss carryover as well as the utilization of the carryover on a separate company basis.[4] This approach prevents the offset of one member's loss carryover against the future income of another member.

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[2] O'Neill and Ruez, State and Local Tax Issues to a Debtor in Bankruptcy, in Bezozo and Phelan, *Bankruptcy Taxation: Critical Current Issues* 532–533 (1991).

[3] O'Neill and Ruez, *supra* note 2, at 535.

[4] *Id*.

(iii) Apportionment

Most states require that apportionment be used to determine the portion of a corporation's income that is attributable to a particular state. Once the net operating loss applicable to a particular state has been calculated, only that loss can be utilized against income from that state.[5]

(c) Bankruptcy Code

Section 346(g)(1)(C) of the Bankruptcy Code provides that, for state or local tax purposes, neither a gain nor a loss will be recognized by a debtor corporation under chapter 11 or 12 on a transfer to an affiliate participating in a joint plan with the debtor or to a successor to the debtor under the plan. However, a gain or loss will be recognized to the same extent that such transfer results in the recognition of gain or loss under I.R.C. section 371. Still, the extent to which a gain or loss will be recognized is questionable. I.R.C. section 371, which was applicable to Chapter X of the Bankruptcy Act, did not apply to Chapter XI. When Chapters X and XI of the Bankruptcy Act were replaced by chapter 11 of the Bankruptcy Code, confusion was created as to the extent to which I.R.C. section 371 would be applicable to a chapter 11 case under the Bankruptcy Code.

In addition, I.R.C. section 371 was repealed by the Bankruptcy Tax Act of 1980 and replaced by the "G" reorganization under I.R.C. section 368. Until the Bankruptcy Code is revised, it could be argued that the repealed I.R.C. section 371 is still applicable because the Bankruptcy Code still states that it applies. I.R.C. section 371 provided that no gain or loss would be recognized if property of a corporation is transferred, in pursuance of an order of the court having jurisdiction over the corporation under Chapter X of the Bankruptcy Act, to another corporation organized or used to effectuate a plan of reorganization, in exchange solely for stock or securities in the other corporation. If the property received consisted not only of stock or securities permitted to be received without gain recognition, but other properties or money considered as boot, no gain would be recognized if the corporation receiving the property distributed it to its creditors or shareholders under the terms of a plan of reorganization. If the money was not distributed in accordance with a plan of reorganization, then the corporation would recognize the gain on transfer to the extent of the boot that was received and not distributed.

Section 346(g)(2) of the Bankruptcy Code provides that the transferee, in a transfer of a kind specified in subsection (g), is to take the property with the same character, basis (as adjusted under subsection (j)(5) for income from debt discharge), and holding period.

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[5] *Id*. at 536.

§ 8.4 BANKRUPTCY ESTATE

(a) Separate Estate

Section 346(b) of the Bankruptcy Code provides that a separate estate is created when a chapter 7, chapter 11, or chapter 12 petition is filed by an individual. As is true for federal tax purposes, a separate taxable entity is not created for partnerships and corporations, and these entities will not close their taxable year as of the day the petition is filed. For federal tax purposes, a chapter 11 petition does not result in the creation of a separate estate, because I.R.C. section 1398 provides that a separate estate is created only in chapter 7 or chapter 11.

Corporations are specifically forbidden from bifurcating their state and local income tax periods under 11 U.S.C. Section 346(c)(1) of the bankruptcy code provides, as does IRC section 1399 for federal tax purposes, that no new taxable entity is created when a corporation files bankruptcy. Tax filing dates and consolidation policies are not impacted by the filing of a corporate bankruptcy. While corporations are forbidden from bifurcating their state and local tax periods, bifurcation of the priority of taxes has been allowed. For example, in *O.P.M. Leasing Services Inc.*,[6] the trustee filed Indiana state corporate income tax return and paid all of the tax, including, interest and penalty, for the postpetition portion of that year. The bankruptcy court concluded that administrative treatment was reserved for the tax liability on income earned by the bankruptcy estate after the filing of the petition. Taxes on income earned prior to the filing were considered prepetition.

(b) Short Tax Year

Sections 728(a), 1146(a), and 1231(a) of the Bankruptcy Code together provide that an individual in a chapter 7, chapter 11, or chapter 12 case will terminate the taxable year on the date of the order for relief. Thus, the debtor will file two tax returns in the year when the order for relief is granted. (The order for relief is automatically granted at the time a voluntary bankruptcy petition is filed. In an involuntary case, the court will issue the order for relief after a trial unless the debtor has timely controverted the petition.) One return begins on the first day of the taxable year and ends on the day the bankruptcy petition is filed; the other return covers the period from the first day after the petition is filed to the end of the taxpayer's normal tax year. Note that the state and local tax provisions differ from the federal tax issues in at least three ways:

1. Two tax returns must be filed during the year when the petition is filed; for federal tax purposes, the debtor must make an election by the 15th day of the fourth full month after the petition is filed, in order to file two tax returns for the year when the petition is filed.

[6] *In re O.P.M. Leasing Services Inc.*, 68 BR 979 (Bankr. S.D.N.Y. 1987).

2. The first tax year ends on the day the petition is filed; when the election is made to file two separate returns for federal tax purposes, the year ends on the day before the bankruptcy petition is filed.
3. Under federal tax law, a short-year election may not be made if the estate has no assets; a similar exception is not provided for state and local tax purposes.

A separate estate is created in the case of a chapter 12 petition; a separate estate is not created for federal tax purposes. In the case of a chapter 13 petition, a separate estate is not created for either federal or state and local tax purposes.

(c) Method of Taxation

Under the state and local tax rules, the separate estate is taxed as an estate. Under the federal tax laws, the bankruptcy estate is taxed as a married person filing a separate return.

The State of California adopted legislation, effective January 1990, under which the federal provisions that govern the taxation of estates of individuals in bankruptcy under chapters 7 and 11 also apply for state tax purposes. The law was modified, however, to reflect California's rates rather than federal rates, and I.R.C. section 1398 dealing with carryback and carryforward of unused administrative expenses was changed to provide that these expenses may be carried forward for only 7 years. A statute of this nature is a state law even though it follows the provisions of the Bankruptcy Code. Approximately 50 percent of the states now have state tax laws that "piggyback" the federal tax laws. However, because the Bankruptcy Code is a federal statute, it has priority over the various state laws. Any state law that conflicts with section 346, 728, 1146, or 1231 of the Bankruptcy Code is not enforceable.

The State of California realized that its statute dealing with the special tax provisions for debtors in bankruptcy was in conflict with section 346 of the Bankruptcy Code and repealed the state law. Effective October 2, 1991, section 17047 of the California statute was repealed as of January 1, 1991. Thus, for all returns that are filed for calendar years 1991 and later, the State of California has officially indicated that sections 346, 728, 1146, and 1231 of the Bankruptcy Code apply. The instructions for Form 541 indicate that the trustee or debtor-in-possession would file Form 541 for an estate in chapter 7, 11, or 12, if the estate has

- Gross income for the taxable year of more than $8,000 (regardless of the amount of the new income);
- Net income for the taxable year of more than $1,000;
- An alternative minimum tax liability.

California again failed to comply completely with the Bankruptcy Code. Section 728 of the Bankruptcy Code provides that, in a chapter 7 case, an individual and a corporation need file tax returns only if the estate has income for the entire period of the case. Another provision should have been added to the California statute to require that, for individuals and corporations, tax returns will be required only if there is net income for the entire period.

(d) Transfer of Property to Estate

Section 346(g)(1) of the Bankruptcy Code provides that neither a gain nor a loss will be recognized on the transfer of property to the estate at the time the petition is filed. This provision for state and local tax purposes is similar to I.R.C. section 1398(f)(1): for federal taxes, there is no gain on transfer. However, section 346(g) of the Bankruptcy Code does not contain a provision, for state and local tax purposes, that explains whether the transfer is or is not considered a disposition for purposes of recapture of any state and local tax credits. If the transfer is considered a disposition for state and local tax purposes, other unfavorable tax consequences might arise, such as the acceleration of income for state and local but not for federal tax purposes. The transfer of an installment obligation to a bankruptcy estate could result in income being accelerated due to the disposition.

Section 346(i) of the Bankruptcy Code provides that the bankrupt estate succeeds to all of the tax attributes of the debtor, including:

1. Investment credit carryover;
2. Any recovery exclusion;
3. Any loss carryover;
4. Any foreign tax credit carryover;
5. Any capital loss carryover;
6. Any claim of right.

The list for state and local tax purposes is nonexclusive because section 346(i)(1) provides that all tax attributes go to the estate. As noted in Chapter 4, this is different for federal tax purposes: the courts have held that only those attributes listed in I.R.C. section 1398 or added by the IRS through the issuance of Treasury Regulations are transferred to the estate. Thus, before the IRS issued Proposed Treas. Reg. section 1.1398-1, passive loss carryovers were transferred to the estate for state and local tax purposes.

Under state and local tax rules, the individual is required to file a petition as of the date the bankruptcy petition is filed. The attributes will therefore go over as of the end of the day on which the petition is filed. It is assumed that the tax liability that may be created as of the day the bankruptcy petition is filed will be a prepetition liability.

(e) Transfer to Debtor

Section 346(g)(1) of the Bankruptcy Code provides that neither a gain nor a loss will be recognized on the transfer (other than a sale) of property from the estate to the debtor. If an abandonment is not considered a sale, there would not be a gain or a loss on the transfer. The provisions regarding the nontaxability of the transfer from the estate to the debtor for state and local tax purposes are not restricted, unlike those governing a transfer for federal tax purposes under I.R.C. section 1398(f) upon termination of the estate.

Section 346(i)(2) of the Bankruptcy Code indicates that, after a case is closed or dismissed, the debtor is to succeed to any tax attribute that was not utilized by the estate. It would appear that, for state and local tax purposes (again, unlike federal tax purposes), the debtor would not be required to file an amended return when a petition is dismissed. Activities of the estate would be reported for state and local tax purposes on the appropriate estate tax forms as long as the case was not closed or dismissed.

According to section 346(i)(2) of the Bankruptcy Code, the time limitations associated with a tax attribute to which the debtor succeeded are suspended during the time the case is pending. There is no comparable provision for federal tax purposes.

(f) Net Operating Loss Carryover and Carryback

Section 346(i)(3) of the Bankruptcy Code provides that the estate may carry back any loss of the estate to a taxable period of the debtor that ended before the order for relief. The debtor may not carry back a loss that he or she sustains while the case is open. However, section 346(i)(3) implies that the debtor may carry back a net operating loss once the case is closed, provided all of the tax attribute was not used by the estate. The Internal Revenue Code does not have a similar provision indicating that the debtor may carry back a loss after the case is closed.

§ 8.5 RESPONSIBILITY FOR FILING TAX RETURNS

(a) Chapter 7

Section 728(b) of the Bankruptcy Code provides that the trustee is responsible for filing the tax returns for an individual, partnership, or corporation. If the estate of an individual debtor or corporation does not have a net taxable income for the entire period of the case, a tax return is not needed. If, on the other hand, the individual or corporate estate does have a net taxable income, then tax returns must be filed for each taxable period during which the case was pending after the order for relief under chapter 7. The trustee for the estate of a partnership is required to file state and local tax returns whether or not the estate has net taxable income.

It would appear that, if a corporation had taxable income for the period prior to the filing of the petition but did not have net taxable income for the entire period the case is pending, no tax return would be required. If no tax return is required, it would be assumed that there would not be any tax liability. Thus, if a corporation that filed a chapter 7 petition on December 1, 1994, had a net income of $200,000 for 1994 (most of which was earned prior to the filing of the petition), but had losses in excess of $200,000 for the other years ending during the time the petition is pending, no taxes would be due. This would be true even though the state tax laws do not provide for the carryback or carryforward of net operating losses.

(b) Chapter 11 or Chapter 12

Section 1146(b) of the Bankruptcy Code provides, in a chapter 11 case, and section 1231(b) of the Bankruptcy Code provides, in a chapter 12 case, that the trustee or debtor-in-possession of an estate of an individual is responsible for filing a tax return for any taxable year ending during the period the case is pending. Because a short-tax-year return must be filed for state and local tax purposes, the trustee or debtor-in-possession is responsible for filing returns for the entire period the debtor is in bankruptcy.

§ 8.6 STAMP TAX

(a) Introduction

Section 1146(c) of the Bankruptcy Code provides: "The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129, may not be taxed under any law imposing a stamp tax or similar tax."

A tax that qualifies under this provision generally has the following characteristics:

- A stamp tax or similar tax is imposed;
- The stamp tax is imposed on the purchaser;
- The stamp tax is imposed in connection with a plan.

Each of these characteristics is discussed in the following sections.

(b) Stamp Tax or Similar Tax

Section 1146(c) of the Bankruptcy Code does not define a stamp tax or similar tax. In general, the courts have held that the essential common element of a stamp tax is the levying of the tax on a written instrument representing a transfer or sale. In *In re Amsterdam Ave. Develt Assoc.*,[7] the court established criteria for a stamp tax or similar tax that have been followed by other courts:

- The amount is determined by the consideration stated in the document;
- Payment is required before the document can be recorded;
- The tax is imposed on a written instrument.

A stamp tax or similar tax has been interpreted to include:

- *Tax imposed on recording liens against the debtor.* The exception has not been applied to purchase money mortgage liens relating to liabilities incurred upon purchase by third parties from the debtor.[8]

[7] 103 B.R. 454 (Bankr. S.D. N.Y. 1989).

[8] *See In re The Baldwin League of Independent Schools*, 110 B.R. 125 (S.D. N.Y. 1990); *In re Eastmet Corp.*, 907 F.2d 1487 (4th Cir. 1990) and *In re Amsterdam Ave., Develt Assoc.*, *supra* note 7.

- *State and local realty transfer taxes.* In *In re Jacoby-Bender, Inc.*,[9] realty transfer taxes were held to be the equivalent of a stamp tax.
- *Gains taxes.* The courts have reached conflicting results on the question of whether section 1146(c) of the Bankruptcy Code applies to state or local gains tax. In *In re 999 Fifth Avenue Assoc., L.P.*,[10] the district court affirmed the bankruptcy court's decision that section 1146(c) of the Bankruptcy Code barred New York State from imposing the state's real property gains tax on the sale of the Stanhope Hotel pursuant to a chapter 11 plan. The district court concluded that the gains tax contained the essential characteristics of a stamp tax. It was imposed on a transaction-by-transaction basis and payable at the time of transfer, without regard to other transfers over time. The consideration paid to the transferor and recited in the deed is essential in assessing the amount of the real property gains tax due. The tax must be paid at the time of the transfer, and the conveyance under state law cannot be recorded before the tax is paid.
- The court concluded that the real property gains tax was not an income tax because the gains tax lacked many of the essential characteristics of an income tax. The tax does not measure changes in the taxpayer's economic status because no allowance is made for depreciation. The tax was not assessed against profitable transactions, because, under New York law, only transfers that exceed $1 million are subject to the tax. (Once the transaction exceeds $1 million, the entire gain is taxed.) In addition, the purchaser may be liable for the tax if the seller does not pay the tax. Thus, the district court concluded that the New York real property gains tax has many of the characteristics of the stamp tax and very few of the income tax.
- In *In re Jacoby-Bender, Inc.*,[11] the bankruptcy court concluded that the New York real property gains tax is an income tax. The court held that the gains tax is not a tax on the transfer, but on the gain realized by the transferor. The court also interpreted the stamp tax to apply to the making and delivery of a deed.
- *Sales and use taxes.* Again, the courts are divided as to the extent that the exception under section 1146(c) of the Bankruptcy Code applies to sales and use taxes. A sales or use tax is often imposed on the sale of personal property that is generally sold without an instrument of transfer. Thus, section 1146(c), if interpreted literally, would not apply because the sale is not effected through an instrument. A literal interpretation would lead to the exemption of the tax for real property transfers and not for personal property transfers. In *Linden Hill Associates Limited Partnership v. Comptroller*,[12] the court held that the sale of personal property pursuant to a chapter 11 plan was not exempt from the Maryland retail sales tax, because the

[9] 40 B.R. 10 (Bankr. E.D. N.Y. 1984), *aff'd on another issue*, 758 F.2d 840 (2d Cir. 1985).
[10] 1991 U.S. Dist. LEXIS 6514 (S.D. N.Y. 1991).
[11] *Supra* note 9.
[12] 1989 Md. Tax LEXIS 13 (1989).

tax is imposed regardless of any instrument of transfer. In *In re A.H. Robins Co.,*[13] the sale of personal property was not subject to the sales tax because of section 1146(c).

- O'Neill and Ruez[14] point out that, even though section 1146(c) may not exempt a transaction from sales tax, most states provide for some form of exemption for casual or isolated sales. State statutes that allow an exemption from the tax for the bulk sale of tangible personal property may require that advance notice be given of the proposed sale, or may limit the exemption to those taxpayers not regularly engaged in the retail sales business.

(c) Imposed on the Purchaser

Section 1146(c) of the Bankruptcy Code forbids the imposition of a stamp tax on the "making or delivery of any instrument of transfer[15]. " It would appear that this section literally applies to the purchaser; however, courts have generally held that both the transferor and the transferee of an instrument are exempt from the tax. In *In re Hans B. Cantrup*,[16] the bankruptcy court held that section 1146(c) applied to a real estate transfer tax that was imposed on the acceptance of a deed and presentation for recording by the transferee. The court concluded that the intent of section 1146(c) was to bar a tax on the transfer, regardless of whether it was presented for recording by the transferor or transferee. A similar decision was made by the bankruptcy court in *In the matter of CCA Partnership*,[17] where the realty transfer taxes were apportioned equally between the grantor and grantee. In *Lake v. Gleason*,[18] the court held that the predecessor section of the Bankruptcy Act (to section 1146(c) of the Bankruptcy Code) did not exempt a grantee who presented a deed to be recorded from the Pennsylvania realty transfer tax.

The exemption would not apply to subsequent transfers by the purchaser. Thus, section 1146(c) of the Bankruptcy Code would not exempt the recording of a mortgage granted by the purchaser to a third-party lender. O'Neill and Ruez suggest that the recording tax may be exempted if the debtor grants the mortgage to the third-party lender and then transfers the property subject to the mortgage.

(d) Under the Plan

Tax must be imposed in connection with a plan that is confirmed under the Bankruptcy Code. Courts have generally held that the tax need only be imposed on a transaction that is consummated on confirmation of the plan or that is

[13] 88 B.R. 742 (Bankr. E.D. Va. 1988).
[14] *Supra* note 2, at 550.
[15] 53 B.R. 104 (D. Colo. 1985).
[16] 53 B.R. 104 (D. Colo. 1985).
[17] 72 B.R. 765 (D. Del. 1987), *aff'd*, 833 F.2d 303, 833 F.2d 304 (3rd Cir. 1987).
[18] 11 Pa. D. & C. 584 (Pa. 1956).

essential to the plan's consummation or confirmation. For example, in *In re Jacoby-Bender, Inc.*,[19] the Second Circuit held that section 1146(c) of the Bankruptcy Code applied to the sale of a building after the plan had been confirmed. Authorization for the sale of the building was not contained in the plan, but the court did obtain subsequent separate approval for the sale. The court held that, because consummation of the debtor's plan depends almost entirely on the sale of the building, the transfer should be regarded as being made under the plan for purposes of section 1146(c).

In *In re Permar Provisions, Inc.*,[20] the bankruptcy court held that section 1146(c) of the Bankruptcy Code applied to the sale of a building before the plan was confirmed because the sale facilitated confirmation of the plan and without the sale, the plan in all probability would not have been confirmed.

In *In re Smoss Enterprises Corp.*,[21] the court held that section 1146(c) of the Bankruptcy Code applied to a sale of property under a prepetition contract that was made prior to confirmation of a liquidating plan. The court determined that the transfer of the property was essential to the confirmation of the plan. The district court, in *In re The Baldwin League of Independent Schools*,[22] approved the mortgage of a building, prior to confirmation of the plan, that provided the sole source of funding for the plan and was necessary for confirmation of the plan.

Even though courts have generally given broad interpretation to the meaning of "under the plan," it is advisable to refer, in the plan or in the disclosure statement, to any completed or proposed transfer of property where section 1146(c) would apply, and indicate that the purpose of the transfer was to effectuate the plan.

(e) Liquidation Sales

The Supreme Court, in *California State Board of Equalization v. Sierra Summit*,[23] held that the state has the power to impose sales and use taxes on liquidations in both chapter 7 and chapter 11. It would also be presumed that any tax imposed by a local taxing authority would apply to liquidation sales. At least three Circuit Courts have held that sales taxes on liquidation sales are an impermissible burden on a bankruptcy liquidation and thus were excluded from section 960 of title 28 of the United States Code.[24] In *Missouri v. Gleick*,[25] the Eighth Circuit held that taxes could be imposed against bankruptcy liquidations. Section 960 of title 28 of the United States Code provides that any officer or agents conducting business under authority of a United States court shall be subject to all federal, state,

[19] 758 F.2d 840 (2d Cir. 1985).
[20] 79 B.R. 530 (E.D. N.Y. 1987).
[21] 54 B.R. 950 (E.D. N.Y. 1985).
[22] *Supra* note 8.
[23] 109 S.Ct. 2228 (1989).
[24] *See In re Leavy*, 85 F.2d 25 (2d Cir. 1985); *California State Board of Equalization v. Goggin*, 245 F.2d 44 (9th Cir. 1957), *cert. denied*, 353 U.S. 961 (1957); *In re Cusato Brothers Int'l, Inc.*, 750 F.2d 25 (11th Cir. 1985).
[25] 135 F.2d 134 (8th Cir. 1943).

and local taxes that are applicable to the business, to the same extent as if the business were conducted by an individual or corporation.

The Supreme Court did not consider the application of section 1146(c) of the Bankruptcy Code to these taxes, but instead ruled that the doctrine of intergovernmental tax immunity or section 960 of title 28 of the United States Code does not prevent states from imposing these taxes on liquidation sales.

§ 8.7 SUMMARY

Major differences exist between the federal and the state and local tax treatments of debtors in bankruptcy. One of the objectives of the drafters of both the Bankruptcy Code and the Bankruptcy Tax Act of 1980 was to provide some similarity between the federal and the state and local tax impact of various transactions by having both the bankruptcy law and the related tax impact decided by federal laws. The state and local tax rules should be modified to track the provisions of the Internal Revenue Code, including but not limited to, sections 108, 368, 381, 383, 1017, 1398, and 1399.

Both bills introduced into the House and Senate in 2001 would have to modify sections 346, 728, 1146, and 1231 of the Bankruptcy Code to generally follow the same provisions that apply for federal income tax purposes. H.R. 975 introduced into the House in 2003 contained similar provisions. Considerable conflicts existed between state and local taxes and federal taxes. Congress indicated at the time the Bankruptcy Reform Act of 1978 became law that the state and local tax issues would be changed when the Congress passed the federal bankruptcy tax laws. A few years later, Congress passed the Bankruptcy Tax Act of 1980 and no action has been taken to eliminate the tax problems that arise because of the differences between the two federal laws. To correct these problems, the proposed amendment to section 346 of the Bankruptcy Code would conform section 346 to that of section 1398, and so on.

CHAPTER NINE

Tax Consequences to Creditors of Loss from Debt Forgiveness

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§ 9.1 INTRODUCTION

The tax problems arising from debt cancellation are generally thought to be less complicated for the creditor than for the debtor. The cancellation generally results in a deduction for bad debts. The tax consequences can become quite involved, however, where the debt is a nonbusiness debt, a security, or a secured debt. Some of these complications are examined in this chapter.

§ 9.2 NATURE OF LOSSES

I.R.C. section 165 deals with losses in general and I.R.C. section 166 deals with bad-debt losses. These sections are mutually exclusive.[1] Most losses that originate from the failure of the debtor to pay debts fall under the provisions of I.R.C. section 166, and not under I.R.C. section 165.

(a) Security Losses

In I.R.C. section 165(g), there is one major exception to the general provision that a bad-debt loss is a section 166 loss. Section 165(g) provides that, when any security that is a capital asset becomes worthless, it is to be deducted in the year in which it becomes worthless and is to be treated as a loss from sale or exchange on the last day of the taxable year.[2] Securities include stock, the right to subscribe to or receive stock, and any bond, debenture, note, certificate, or other evidence of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. Two exceptions to the provisions of I.R.C. section 165(g) are (1) worthless securities held by a bank, which are considered to be bad debts,[3] and (2) securities held by a dealer, which must be treated according to the rules governing inventory.[4]

Losses are deductible under I.R.C. section 165 if three requirements are satisfied:

1. The amount can be proved;
2. The amount to be deducted was not compensated for by insurance;
3. The loss resulted from a closed transaction.

Losses deductible under I.R.C. section 165 include theft, casualty, operating, and disaster losses, in addition to losses from debts evidenced by a security. However, for the latter type of loss to be deductible, the security must be deemed completely worthless.

In general, the closed transaction requirement creates the most problems for taxpayers. I.R.C. section 165(a) provides that "there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." A deductible loss is sustained when there is a completed and

[1] *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934).
[2] *See* footnote 13 and related text for a summary discussion of a taxpayer's basis in stock for which the taxpayer claimed a worthless stock deduction.
[3] Treas. Reg. § 1.166-1(g); Treas. Reg. § 1.582-1.
[4] Treas. Reg. § 1.165-5(g); Treas. Reg. § 1.471-5.

closed transaction.[5] A closed transaction normally involves, among other things, giving up something, completing requirements of a contract, or abandoning property.[6] In other words, it is an event that has been consummated. Thus, for example, a transaction is completed with respect to securities when they become completely worthless or are exchanged or sold. Treas. Regs indicate that substance and not mere form shall govern in determining a deductible loss.

The term *sustained* has not been defined by Congress. Sustained does not mean *accrued,* because all events need not occur to fix the date of the loss, and it does not mean *paid,* because a disposition is not required. Commentators have suggested that *sustained* might be defined as some identifiable event that fixes the actual loss and the amount thereof.[7] This definition might allow a deduction for a business security where there is a permanent decline in value. However, the courts have not viewed *sustained* in this manner. The IRS has maintained that, until the security is sold or some other disposition of property has occurred, there remains a possibility that the taxpayer may recoup the adjusted basis of the property.[8]

(b) Loan Guarantees

In *Uri v. Commissioner,*[9] the Tenth Circuit held that loan guarantees do not increase the shareholder's basis in S corporation stock.[10] Cathaleen Uri and Stevens Townsdin were shareholders in an S corporation formed to renovate an old opera house. The corporation borrowed money from a bank and had the loan secured by the corporation's assets and personally guaranteed by Uri and Townsdin. The corporation lost money, and the Small Business Administration sent Uri and Townsdin a demand for satisfaction on their personal guarantees. They each filed chapter 7 bankruptcy petitions, and their personal guarantees were discharged in bankruptcy. Eventually, the corporation failed, and it filed a chapter 7 petition.

The basis of Townsdin and Uri's stock in the corporation was consumed by pass-through losses that were claimed on their 1981 returns. However, on their returns for 1982 and 1983, they claimed their pro rata share of the corporation's losses to the extent of their pro rata share of loans that were guaranteed by them. The IRS disallowed the losses, and Uri and Townsdin contested the deficiencies determined against them. The Tax Court held that their personal guarantees did not increase their basis in the S corporation stock. The Tenth Circuit affirmed the decision of the Tax Court. Citing its decision in *Goatcher v. United States,*[11] the Tenth Circuit declined to recharacterize the loan-guaranteed transaction as a loan to Uri and Townsdin.

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[5] Treas. Reg. § 1.165-1(d).

[6] When a Loss Is Deductible and How Much Can Be Deducted Depends on the Nature of the Loss, 14 *Tax'n for Acct*. 119 (1975).

[7] Natbony, Worthlessness, Debt-Equity, and Related Problems, 32 *Hastings L. J.* 1407, 1412 (1981).

[8] See Treas. Reg. § 1.1001-1(c).

[9] 949 F.2d 371 (10th Cir. 1991).

[10] Section 165(1) provides an ordinary loss deduction for losses on deposits resulting from bankruptcy or insolvency of certain financial institutions suffered by "qualified individuals" (generally those other than owners or officers of those institutions). *See Fincher v. Commissioner*, 105 T.C. 126 (1995) (denying deduction under I.R.C. § 165(1) and also under I.R.C. § 166).

[11] 944 F.2d 747 (10th Cir. 1991).

A Tax Court decision denying a nonbusiness bad debt deduction claimed by a taxpayer that purchased real property at a bankruptcy sale and thus discharged a note that had been personally guaranteed, was affirmed by the 5th Circuit.[12]

The Fifth Circuit found no admissible proof sufficient to vary the form of the agreement from the satisfaction of a guarantee. The court noted that the taxpayer, because of his control over the corporation and the joint venture, was the de facto owner of the property during this entire scenario and that the taxpayer just improved his position as property owner as a result of the bankruptcy sale. According to the Fifth Circuit, the sale made it possible for him to get the financing required to satisfy his previous obligation.

Other Circuits have taken a different approach and have concluded that a shareholder in an S corporation who personally guarantees a debt of the corporation may increase his or her basis in the corporation by the amount of the debt where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation.[13]

§ 9.3 BUSINESS AND NONBUSINESS LOSSES

(a) Introduction

A creditor generally is entitled to a deduction for the settlement of a debt for less than the creditor's basis in the debt. The deduction is either a bad debt deduction under I.R.C. section 166 or a loss under I.R.C. section 1271(a)(1). Section 166 provides corporations with an ordinary deduction for any debt that becomes wholly worthless during the taxable year, and allows the Secretary discretion to allow a corporation a deduction for a debt that is partially worthless to the extent the debt is "charged off" during the taxable year. Section 1271(a), however, provides that amounts received by the creditor on "retirement" of any debt instrument shall be considered as amounts received in exchange thereof. In this case, the creditor would receive capital loss treatment. Thus, whether a corporate creditor is entitled to an ordinary deduction or a capital loss for the settlement of a debt is somewhat ambiguous and the treatment may depend upon whether the debt is considered to be charged off or retired.[14]

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[12] *Smith v. Commissioner*, 65 F.3d 37 (5th Cir. 1995).

[13] *See Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) and *Sleiman v. Commissioner*, 187 F.3d 1352, 1357 (11th Cir., 1999).

[14] *But see* Field Service Advice 1999-1043 199 TNT 127-71 (July 2, 1999). In 1992 Field Service Advice, the IRS held that a creditor treats stock received from the debtor in cancellation of a debt as payment on the debt to the extent of the fair market value of the stock on the date of the cancellation. If the value of the stock is less than the creditor's basis in the debt and the requirements of section 166 are met, the creditor may deduct the difference as a section 166 bad debt deduction. The IRS does not explore the possibility that the cancellation of the debt constituted a "retirement" of the debt for purposes of section 1271(a). The IRS also stated that when the creditor subsequently claimed a worthless stock deduction under section 165(g), the creditor's basis in the stock is the fair market value of the stock on the date of the debt cancellation.

(b) Noncorporate

For an individual or partnership, the loss is only deductible as an ordinary loss if the creditor can show that the debt was acquired or created in connection with the creditor's trade or business.

There is no authoritative definition of what constitutes a trade or business. Two tests have emerged from the voluminous case law: (1) the activity in issue must be regular and continuous, as opposed to isolated, and (2) it must be intended to result in a profit. Additionally, the intent of the taxpayer is important in deciding whether certain activities constitute a trade or business.[15]

Business bad debts give rise to ordinary business losses, and therefore they may be carried back 3 years and forward 15 years if the taxpayer's income is insufficient to absorb the deduction in the year the loss is realized. When the loss fails to qualify as a business bad debt, it is deductible as a short-term capital loss. The nonbusiness bad debt is considered with other short-term capital losses and is used first to offset the individual's capital gains. Any balance may then be used to reduce ordinary income up to a maximum of $3,000 per year. Any unused balance may be carried forward for the individual's lifetime.

In order to establish a bad debt as a business loss for an individual or partnership, the taxpayer must first show that the transaction created an obligation. For example, if it can be shown that the transaction was a gift or a contribution of capital, any subsequent loss will not be allowed as a business bad debt.[16] Any loss from a transaction construed as a capital contribution would be subject to the provisions of I.R.C. section 165.

The bankruptcy court held that an individual is not entitled to bad debt deductions for the bad business losses, because his only connection to the businesses was in the form of investments or loans.[17] The court concluded that the debt (investment) did not satisfy section 166's requirement that the debt arise in connection with the taxpayer's business and that capital contributions disguised as loans do not qualify.

(c) Debt or Equity

In certain instances, the IRS will contend that debt is really an equity interest and will deny the shareholders the tax advantages of debt financing. If the debt instrument has too many features of stock, it may be treated as a form of stock, and principal and interest payments will be considered dividends.[18]

In determining whether a debtor-creditor relationship or a shareholder-corporation relationship exists, the courts will consider both substance and form. The debt should be in proper legal form, should bear a legitimate rate of interest, should have a definite maturity date, and should be repaid on a timely basis. Payments should not be contingent on earnings, and the debt should not

[15] The two-pronged test is illustrated in *Byers v. Commissioner*, 57 T.C. 568 (1972), *aff'd*, 472 F.2d 590 (6th Cir. 1973), and in *Cooper v. Commissioner*, 61 T.C. 599 (1974).

[16] *See* Treas. Reg. § 1.166-1(c).

[17] *In re Healey*, 228 B.R. 332 (Bankr. N.D. Ga. 1998).

[18] *See* I.R.C. § 385.

be subordinated to other liabilities.[19] The Sixth Circuit[20] identified the following 11 factors that should be considered in determining if the instrument should be classified as debt or equity:

1. Names given to the instruments, if any evidencing the indebtedness
2. Presence or absence of a fixed maturity date and scheduled payments
3. Presence or absence of a fixed rate of interest and interest payments
4. Source of the repayment
5. Adequacy or inadequacy of capitalization
6. Identity of interest between the creditor and stockholder
7. Security, if any, for advances
8. Corporation's ability to obtain financing from outside lending institutions
9. Extent to which the advances were subordinated to the claims of outside creditor
10. Extent to which the advances were used to acquire capital assets
11. Presence or absence of a sinking fund to provide repayment

These factors have also been adopted by courts[21] in bankruptcy proceedings to determine if the debt should be reclassified as equity for purposes of claim or interest classification. Additionally, two other factors were identified in *Outboard Marine Corp.*[22] as being relevant for bankruptcy purposes:

1. Ratio of shareholders, loans to capital
2. Amount or degree of shareholders' control

The statutory and regulatory approach to this issue (I.R.C. section 385) is discussed in § 7.(a).

(d) Business Motive

Once it is ascertained that the transaction gave rise to real debt, it is then necessary to show that the motive behind the debt was business. In *United States v. Generes,*[23] the Supreme Court held that, for a loss to qualify as a business bad debt, the taxpayer had to show that the "dominant" motive for the undertaking which gave rise to the debt was attributable to the taxpayer's business; a mere

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[19] *See, e.g., J.S. Biritz Constr. Co. v. Commissioner*, 382 F.2d 451 (8th Cir. 1962); *Estate of Miller v. Commissioner*, 239 F.2d 219 (9th Cir. 1956). *See also Peoplefeeders, Inc.* and *Subsidiaries v. Commissioner*, 77 T.C.M. (CCH) 1349 (1999) (net intercompany payments from a subsidiary to a parent not treated as loans to the parent in the case in which there was no written promissory note or security agreement and a lack of repayment terms, interest, or collateral).

[20] *Roth Steel Tube Co. v. Commissioner*, 800 F. 2d 625, 630 (6th Cir. 1986.

[21] *See, for example, AutoStyle Plastics, Inc.*, 269 F.3d. 726 (6th Cir. 2001).

[22] 2003 U.S. Dist. 12564 (E.D. Ill. 2003).

[23] 405 U.S. 93 (1972).

"significant" motive was inadequate to establish the required "proximate" relationships.[24]

It is not uncommon for individual owners to lend money to their troubled corporation or make payments on debt they personally guaranteed. The question that often arises in such cases is whether the worthless loan or payment of a guarantee is a business debt, a nonbusiness debt, or a contribution to capital. This is the problem the Tax Court dealt with in *Slater v. Commissioner*.[25]

In *Slater,* the taxpayers' company had obtained loans in February 1979, which the taxpayers had to personally guarantee. The company was insolvent by August 1979, and the Slaters paid $450,000 of principal from their personal account. The taxpayers declared bankruptcy, did not include themselves as creditors of the company, and were aware that they would not be reimbursed for amounts paid to the creditors. The taxpayers later altered the company's books, changing the loan paid in 1980 from a debt to the bank to a debt to themselves. On their original 1980 return, the taxpayers claimed a $446,290 nonbusiness bad debt deduction because the account was worthless. Later, the taxpayers filed an amended return changing the characterization of the debt from a nonbusiness to a business bad debt.

The IRS disallowed the deductions, arguing that the debtor-creditor relationship and the amount, timing, and character of the debt were not established. The IRS claimed that the advances were to capital. The Tax Court held that the payments for the company's debts were contributions to capital and not deductible bad debts under I.R.C. section 166.

The court rejected the taxpayers' arguments, based on *Generes,* that the advances were made to protect their salary income and, therefore, should be classified as business bad debts. The Tax Court noted that the taxpayers failed to prove either a fixed date or reasonable expectation of repayment, did not offer notes or other evidence of indebtedness, and had no provision for interest.[26] Generally the taxpayer must show that he or she entered into a valid debtor-creditor relationship, that the loans were not contingent, and that the loans were made with a reasonable expectation, belief, and advance that the loans would be repaid. Funds advanced based on the condition that the funds will be repaid only when the entity becomes financially stable does not constitute a loan. On the other hand if, while there is risk, the entity may not have funds to repay the debt, the entity has an obligation to make the loan payments anyway and there is no express or implicit agreement between the parties that the repayment was contingent on the financial success, it has been ruled the advances were debt.[27]

In *Baggao v. Commissioner*,[28] the Tax Court held that an amount that had been advanced to the attorney on behalf of the business was for nonbusiness purposes.

[24] Treas. Reg. § 1.166-5(b).
[25] 56 T.C.M. (CCH) 1135 (1989).
[26] *See Zimmerman v. United States*, 318 F.2d 611 (9th Cir. 1963).
[27] *Klaue v. Commissioner*, T.C. Memo 1999-151 (U.S. Tax Court Memos, 1999).
[28] 63 T.C.M. (CCH) 2778 (1992).

James and Norma Baggao purchased a hotel in Odessa, Texas, and formed Golden West Enterprises, Inc., transferring the hotel to it. The Baggaos were the sole shareholders and officers of Golden West. They operated the hotel and were paid salaries by Golden West. The hotel was not successful and when Golden West was threatened with foreclosure of the hotel property, a chapter 11 petition was filed in December 1991. Golden West retained Wylie James as counsel and the Baggaos paid $22,000 to James on behalf of Golden West. They expected to be repaid on the sale of the hotel. The plan of reorganization provided for the sale of the property, which occurred after the plan was confirmed, and the proceeds were used to pay creditors. The plan did not provide for the payment of the $22,000 advance to the attorney. As a result, the Baggaos deducted $22,000 as a bad debt from sales on Schedule C of their 1982 joint federal income tax return.

The Tax Court held that the $22,000 payment was a nonbusiness bad debt that could only be claimed as a short-term capital loss pursuant to I.R.C. section 166(d)(1)(B). The court reasoned that the Baggaos' dominant motivation in making the payment was to protect their investment in Golden West by slowing down the foreclosure process and not to reorganize Golden West's business for continued operations.

The court also held that the Baggaos were liable for a substantial understatement penalty because they did not show substantial authority for their position. The court also noted that they did not disclose adequate facts with respect to the payment on their return.

The Ninth Circuit[29] also examined a deduction claimed by a taxpayer for bad debts relating to losses from a partnership in which the taxpayer held an interest. The Ninth Circuit concluded that the taxpayer failed to show that the partnership's dominant motive for advancing the funds was connected to the trade or business of the partnership, or that the loss from the bad debt was incurred in the partnership's trade or business.

(e) Corn Products Doctrine

When a security that is a capital asset becomes worthless, it is deducted as a capital loss and not as an ordinary loss. One major exception to this rule was established in *Corn Products Refining Co. v. Commissioner*.[30] The Supreme Court ruled that the disposition, at a loss, of stock acquired for the purpose of obtaining a source of raw materials resulted in an ordinary loss. The principle established in this case suggests that a loss on the disposition of property that normally would be classified as a capital asset and considered as an investment, but which was in fact acquired for a business purpose, would give rise to an ordinary loss.

Cases subsequent to *Corn Products* have established that stock held to generate business,[31] to obtain a selling agency account or to ensure a source of

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[29] *Yamamoto v. Commissioner*, 958 F.2d 380 (9th Cir. 1992), *reported in full*, 1992 U.S. App. LEXIS 6397.

[30] 350 U.S. 46 (1955).

[31] *See Steadman v. Commissioner*, 424 F.2d 1 (6th Cir. 1970), *cert. denied*, 400 U.S. 869 (1970).

supply,[32] and to expand into a related line of business[33] is not a capital asset. The IRS issued Rev. Rul. 78-94[34] in an attempt to use the court's decision in *W.W. Windle Co. v. Commissioner*[35] to broaden the meaning of capital asset in order to reduce the opportunity for the taxpayer to have an ordinary loss. The *Windle* court held that "stock purchased with a substantial investment purpose is a capital asset even if there is a more substantial business motive for the purchase."[36]

In Notice 87-68,[37] the IRS announced that it would suspend all Revenue Rulings based on *Corn Products,* pending the outcome of *Arkansas Best and Subsidiaries v. Commissioner*[38] in the Supreme Court. In *Arkansas Best,* the Court of Appeals for the Eighth Circuit reversed the tax court and held that a holding company sustained capital losses on all its sales of stock in a bank subsidiary. The Eighth Circuit concluded that capital stock that is not held by a dealer (or otherwise within the exceptions listed in I.R.C. section 1221) is always a capital asset under section 1221, regardless of the taxpayer's business purpose in acquiring or holding the stock. This decision created a conflict in the Circuits, virtually assuring a Supreme Court resolution.

As the IRS had predicted in Notice 87-68, the Supreme Court did significantly limit the application of the *Corn Products* Doctrine in *Arkansas Best.* The Court held that a taxpayer's motive in acquiring stock that the taxpayer later sold was not relevant in determining the nature of the loss—ordinary or capital. The Court held that the stock was a capital asset, because it did not fall under the statutory exceptions under I.R.C. section 1221.[39] Thus, contrary to the suggestion in *Corn Products,* stock acquired for business purposes could not be subject to ordinary loss treatment.

(f) Small Business Exception

Under I.R.C. section 1244, an individual is allowed to deduct a loss on sale, exchange, or worthlessness of qualifying stock as an ordinary loss rather than as a capital loss. To qualify under section 1244, which was enacted to help attract financing for small businesses, the corporation must, among other requirements, qualify as a small business corporation and issue stock for money or other property (other than stock and securities). Only the first $1 million of stock may qualify as section 1244 stock. The ordinary loss treatment is allowed for a loss of up to $50,000 ($100,000 on a joint return). Any excess is considered a capital loss. Ordinary loss treatment is available only to the original owner of the stock. If the

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[32] *See Waterman, Largen & Co. v. United States*, 419 F.2d 845 (Ct. Cl. 1969), *cert. denied*, 400 U.S. 869 (1970); *Booth Newspapers, Inc. v. United States*, 303 F.2d 916 (Ct. Cl. 1962).

[33] *See Schlumberger Technology Corp. v. United States*, 443 F.2d 1115 (5th Cir. 1971).

[34] 1978-1 C.B. 58, *rev'g* Rev. Rul. 75-13, 1975-1 C.B. 67.

[35] 65 T.C. 694 (1976), appeal dismissed on jurisdictional grounds, 550 F.2d 43 (1st Cir. 1977), *cert. denied*, 431 U.S. 966 (1977).

[36] 65 T.C. at 712. For a detailed analysis of Windle, *see* Natbony, Whither Windle 24 *St. Louis U. L. J.* 67 (1969).

[37] September 29, 1987.

[38] *Arkansas Best Corp. v. Commissioner,* 800 F.2d 215 (8th Cir. 1986), *aff'd,* 485 U.S. 212 (1988).

[39] Treas. Reg. § 1.1502-13(g).

stock is transferred to another party, the stock loses its section 1244 character. The Tax Reform Act of 1984 amended I.R.C. section 1244 to allow the issuance of preferred stock. Stock issued prior to July 18, 1984 had to be common stock.

(g) Affiliate Corporation

I.R.C. section 165(g)(3) provides that losses from a security (debt or equity) of a corporation that is an *affiliate* corporation are ordinary losses to which the limitations on capital losses do not apply.

In the case in which an affiliated group files a consolidated income tax return, the intercompany obligation rules[40] apply to the discharge of intercompany obligations, (i.e., when one member of the consolidated group is the creditor and another member is the debtor). The intercompany obligation rules generally prevent the group from having overall income or loss when the creditor member claims a bad debt deduction on the discharge of amounts advanced to another member, and the debtor member would otherwise exclude the discharge of debt from income under an exception in I.R.C. section 108(a). Specifically, the intercompany obligation rules provide that I.R.C. section 108(a) does not apply to intercompany obligations.[41] Thus, the creditor member's bad debt deduction is effectively offset by the debtor member's discharge of indebtedness income. Under the consolidated investment adjustment rules, the shareholder member's basis in the debtor member would increase by the amount of the discharge of indebtedness income recognized by the debtor member.[42] One might think that the shareholder member is entitled to a worthless stock deduction and, if so, effectively convert (through the operation of the investment adjustment rules) the creditor member's bad debt deduction into a worthless stock deduction; however, as discussed below, the worthless stock deduction (or a portion thereof) may be disallowed.

In a consolidated group context, the "loss disallowance rule" may apply to deny or limit the amount of a worthless stock deduction with respect to stock of a member of the group.[43] The loss disallowance rule was designed to permit a worthless stock deduction for actual economic losses, while denying a tax benefit for "artificial" stock losses created through the consolidated investment adjustment rules; however, the loss disallowance rule is not so finely tuned to permit all economic losses to be deducted. The loss disallowance rule disallows stock losses of subsidiaries to the extent of three factors:

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[40] *See* Treas. Reg. § 1.1502-13T(g)(3)(ii)(B)*(2)* and § 1.1502-13(g)(5), Example 3(d). *See* § 2.9(a)(IV) and note 314.

[41] To avoid duplication of income and losses when a subsidiary is disposed, the investment adjustment rules require the basis of stock of a subsidiary of a consolidated group to be: increased by the subsidiary's taxable and tax-exempt income, and decreased by the subsidiary's taxable loss (when used by the group), noncapital, nondeductible expenses, and distributions on its stock. Treas. Reg. § 1.1502-32(b)(2).

[42] *Supra* note 38, 485 U.S. at 218.

[43] Treas. Reg. § 1.1502-20.

1. Extraordinary gains reflected in stock basis under the investment adjustment rules;[44]
2. Positive investment adjustments reflected in stock basis under the investment adjustment rules (exclusive of extraordinary gains);[45] and
3. Duplicated losses.[46]

Stock losses in excess of the sum of these items are not disallowed by the loss disallowance rule.

Extraordinary gain dispositions include discharges of indebtedness, and to the extent discharges of indebtedness are included in stock basis, such amounts would be disallowed under the loss disallowance rule. Thus, the interplay of the intercompany obligation rule, the stock disallowance rule, and the investment adjustment rules can deny a consolidated group a deduction for an economic loss.[47]

In order for a corporation to be an affiliate of a parent corporation, two tests must be met. First, the parent must directly own the subsidiary's stock, possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock. Second, more than 90 percent of the subsidiary's aggregate gross receipts for all taxable years must have come from sources other than royalties, rents (except rents from the rental of properties to employees in the ordinary course of business), dividends, interest (except interest received on deferred payments from the sale of operating assets), annuities, and gains from sales or exchanges of stocks and securities. In computing the 90 percent test, the total gross receipts are combined for all taxable years; they are not considered separately for each individual year.

Although there is no specified holding period, once a security appears worthless, the purchase of additional shares to meet the 80 percent test will not result in an ordinary loss. In order for I.R.C. section 165(g)(3) to apply, the subsequent purchase of stock must have a legitimate business purpose other than tax avoidance.[48] It would appear that the determination of a business purpose is made independently of whether the debt is secured.

One commentator has suggested that it may be possible to obtain additional tax benefits after the claim for a worthless security loss of an affiliate, if a new business is put into the shell and the net operating loss carryovers of the subsidiary are applied against subsequent earnings.[49]

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[44] Treas. Reg. § 1.1502-20(c)(2)(i).

[45] Treas. Reg. § 1.1502-20(c)(2)(ii).

[46] Treas. Reg. § 1.1502-20(c)(2)(vi).

[47] For a detailed discussion of the interaction of the loss disallowance rule, the intercompany obligation rule, and the investment adjustment rules, see Yates, Banks, and Rainey, "Deducting Your Loss on Winding Up a Purchased Subsidiary: A Lost Cause?," Vol. 50, No. 1, *The Tax Executive* 19 (Jan.-Feb. 1998).

[48] *See* Treas. Reg. § 1.165-5(d)(2)(ii); *Hunter Mfg. Corp. v. Commissioner,* 21 T.C. 424 (1953).

[49] Briskin, "How Advanced Planning Can Yield Maximum Tax Benefits Out of Losses on Stock or Debts," 50 *J. Tax' n* 236 (1979). *See Textron, Inc. v. Commissioner,* 418 F. Supp. 39 (D.R.I. 1976), *aff'd,* 561 F.2d 1023 (1st Cir. 1977), Private Letter Ruling 9425024 (March 25, 1994) (creditor-parent entitled to an I.R.C. § 165(g)(3) deduction and an I.R.C. § 166 deduction upon the conversion of its insolvent subsidiary into a *societe en nom collectif* (a partnership). *See also* Private Letter Ruling 9610030 (December 12, 1995).

(h) Impact on Earnings and Profit

As noted earlier, a deduction for a worthless security is taken on the last day of the taxable year. A problem arises in regard to the date to use for earnings and profits distribution. Because earnings and profits include the excess of capital losses over capital gains,[50] the timing of the deduction is important for midyear distributions. It has been suggested that, because earnings and profits are not governed by artificial recognition provisions, the date of worthlessness should be used.[51]

§ 9.4 DETERMINATION OF WORTHLESSNESS

(a) Introduction

Securities that fall under the provision of I.R.C. section 165(g) and nonbusiness bad debts (I.R.C. section 166) must be totally worthless before a deduction will be allowed.[52] Business bad debts can be deducted when they become partially worthless to the extent charged off in the taxable year. This partial deduction is optional and the taxpayer can elect to wait until the debt becomes wholly worthless, or until it is finally closed out, before deducting the loss. The taxpayer must continue as the owner of the claim for the deduction to be allowed for partial worthlessness. If the claim is sold or exchanged, a loss would be allowed on the exchange but not as a bad debt. Thus, if a creditor accepts stock from a debtor in bankruptcy in exchange for the debt, a loss on exchange would be allowed rather than a bad debt loss.[53]

(b) Meaning of Worthlessness

Although the term *worthless* is not defined in the code, *lacking monetary value* is the most commonly accepted meaning. The taxpayer has the burden of proving that the security is worthless. As proof, the taxpayer must identify those events in the current year and in prior and subsequent years establishing that the security became worthless that particular year. Because the loss is deductible only in the year in which the security became worthless, the timing of worthlessness must be established as well as the fact that the security is worthless. If the worthlessness is determined to have occurred in prior years, the taxpayer must file an amended return in order to receive the benefit of the loss. I.R.C. section 6511(d) extends the statute of limitations to 7 years for these losses, to avoid placing an undue hardship on the taxpayer.[54] Even with this extension, where there is

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[50] Treas. Reg. § 1.312-7(b)(1).

[51] Natbony, *supra* note 7 at 1420.

[52] *See Delk v. Commissioner*, 113 F.3d 984 (9th Cir. 1997) (The Tax Court denied taxpayer's worthless stock deduction even though stock was canceled and shareholders were required to invest additional funds in order to receive stock in the reorganized company. The Ninth Circuit reversed the Tax Court decision and allowed the deduction.)

[53] *Benedum v. Granger*, 180 F.2d 564 (3d Cir. 1950), *cert. denied*, 340 U.S. 817 (1950).

[54] The Economic Recovery Tax Act of 1981 extended the loss carryover period to 15 years (I.R.C. § 172). The time period in I.R.C. § 6511(d), however, was not changed.

doubt as to when the deduction is allowed, the best strategy under most circumstances is to take the deduction during the earliest year possible. If the IRS objects to the timing, the deduction will still be available in subsequent years.

Taxpayers note for $2.1 million was determined to be totally worthless by the district court in 1986. Subsequent to this date, the taxpayer received $240,000 in 1993 and 1994 and has the potential for another $65,000. The Seventh Circuit, reversing the decision of the district court, emphasized the importance of total worthlessness for nonbusiness bad debts, particularly in the intrafamily setting in which nonbusiness debts are most commonly encountered. The court noted that the deduction is unavailable if even a modest fraction of the debt can be recovered. The Court held that although the debt had lost most of its value, it was not worthless.[55] If the event that caused the bad debt loss is a fraudulent transfer , the deduction may be disallowed.[56]

(c) Burden of Proof

The burden of establishing that the stock was worthless and that the worthlessness occurred during the year reported rests with the taxpayer. The taxpayer is expected to use sound business judgment in determining the year the debt became worthless, and the courts normally apply an objective test of reasonableness in determining whether the year reported by the taxpayer is valid.[57]

The taxpayer is not required to be an incorrigible optimist and establish impossibility of eventual recoupment.[58] However, the taxpayer must establish proof by reasonably convincing evidence[59] or preponderance of evidence.[60]

Commentators have suggested three steps to support the claim that a tax deduction due to worthlessness is warranted:[61]

1. Establish a cost or other basis—a deduction cannot exceed the taxpayer's basis. The Commissioner and the court will carefully examine all supporting records to establish that the basis is properly documented.[62]
2. Establish the value of stock at the end of the previous year or the beginning of the year the deduction is claimed. If this value cannot be documented, the fact of worthlessness will be assumed, but the year will not have been established and the statute of limitations may prevent any

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[55] *Buchanan v. United States,* 87 F.3d 197 (7th Cir. 1996).

[56] *United States v. Chavin*, 316 F.3d 666, 680 (7th Cir., 2002).

[57] *See Washington Institute of Technology, Inc. v. Commissioner*, 10 T.C.M. (CCH) 17 (1951).

[58] *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398 (1927).

[59] *Royal Packing Co. v. Commissioner*, 22 F.2d 536 (9th Cir. 1927).

[60] *Mohr v. United States*, 168 F. Supp. 734 (D. Va. 1959), *rev'd and remanded on other grounds*, 274 F.2d 803 (4th Cir. 1960).

[61] *Natbony, supra note* 7 at 1428-30. *See also Buchanan v. United States*, 87 F.3d 197 (7th Cir. 1996) (holding taxpayers not entitled to a nonbusiness bad debt deduction and describing the worthlessness test as "no reasonable prospect of recovering a significant, though in the sense of nontrivial, fraction of [the amount owed.]"), *rev'g* 892 F. Supp. 1073 (N.D. Ill. 1995).

[62] *See Malmstedt v. Commissioner*, 578 F.2d 520, 524 (4th Cir. 1978); *Hunt v. Commissioner*, 82 F.2d 668, 671 (5th Cir. 1936).

deduction. One way to establish value is to show that an active and free market existed for the stock in the preceding year.[63]

3. Establish that the debt became worthless in the year alleged. The loss must be deducted in the year sustained.

(d) Security as Debt

In establishing worthlessness, it is necessary to consider two factors: (1) the liquidation value of the security, and (2) the future value the security may acquire through foreseeable operations. In *Morton v. Commissioner*,[64] the court described the requirements as follows:

> "From an examination of these cases it is apparent that a loss by reason of the worthlessness of stock must be deducted in the year in which the stock becomes worthless and the loss is sustained, that stock may not be considered as worthless even when having no liquidating value if there is a reasonable hope and expectation that it will become valuable at some future time, and that such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of the corporation, or the appointment of a receiver for it. Such events are called "identifiable" in that they are likely to be immediately known by everyone having an interest by way of stockholdings or otherwise in the affairs of the corporation; but, regardless of the adjective used to describe them, they are important for tax purposes because they limit or destroy the potential value of stock."[65]

Thus, to be deductible the security must have no liquidation value and have a lack of future potential. Both of these factors are required. For non-secured-debt securities, even where the prospects for the future are nil, it must be established that the assets of the debtor are not adequate to cover any of the unsecured debt before the deduction would be allowed.

(i) Identifiable Event

Some of the events that have been identified as helpful in determining worthlessness are:

- Liquidation or reorganization of the corporation, or the decision to take such action;
- Sale or foreclosure of significant assets;[66]

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[63] *G.E. Employees' Secur. Corp. v. Manning*, 137 F.2d 637, 641 (3rd. Cir. 1943).
[64] 38 B.T.A. 1270 (1938), *nonacq*. 1939-1 C.B. 57, *aff'd*, 112 F.2d 320 (7th Cir. 1940).
[65] 38 B.T.A. at 1278.
[66] *See* Private Letter Ruling 199951011 (September 17, 1999) in which the IRS ruled that a parent company's two holding companies (S1 and S2) may claim a worthless securities deduction under section 165(a) on their stock investment in S3 when S3 sold its operating assets at an arm's length price to a third party. After the sale, S3 was insolvent. In addition, because S3 sold all of its operating assets, there were no assets to generate income that could be distributed to S1 or S2. Thus, the S3 stock was worthless in the hands of S1 and S2. Furthermore, the loss was an ordinary loss, because S3 was affiliated with S1 and S2 within the meaning of section 165(g)(3). *G. E. Employees Secur. Corp. v. Manning*, 137 F.2d 637, 641 (3d Cir. 1943).

- Bankruptcy or insolvency;
- Operating deficit with a lack of potential for future operations;
- Failure to obtain continuing financing arrangements.

It often takes two or more of these events to substantiate worthlessness. The filing of a bankruptcy petition alone does not indicate that the security is worthless.

Typically, a finding of worthlessness will flow from a series of events rather than a single episode. These events often take place over a period of several years. One event affects the loss transaction prior to the year of deduction; another event closes the transaction giving rise to the deduction claim; and events occurring subsequent to the deduction year confirm that the claim was timely and appropriate. The taxpayer should, therefore, consider events occurring before, during, and after the loss, when making or seeking to prove a claim.

The test of worthlessness is objective; the taxpayer's attitude and conduct are relevant facts. For example, if a taxpayer continues to make loans to a company that is experiencing serious difficulties, the IRS may conclude that the taxpayer thought the stock continued to have some value, and a deduction claim would fail.[67]

Thus, the attitude and conduct of the taxpayer toward the debt are important, and the IRS will look for properly kept records, normal business loan procedures, regular board of directors' minutes documenting finances and business reversals, and arm's-length dealings with the corporation and third parties.[68] Conflicting decisions can be reached on similar stock, and decisions are not binding in subsequent litigation because each case is based on the number and nature of each taxpayer's arguments for worthlessness.[69]

The event used to identify the loss must present facts to indicate that the loss was sustained. It is not enough just to show that the loss is imminent.[70] For example, an excess of liabilities over assets that are valued properly may be used to establish worthlessness.[71] However, the taxpayer will be denied a deduction for securities when no identifiable event indicates worthlessness for the tax year, or no evidence is presented that the liabilities exceed the assets.[72]

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[67] *Singer v. Commissioner*, 34 T.C.M. (CCH) 337 (1975), *aff'd*, 560 F.2d 196 (5th Cir. 1977).

[68] Natbony, *supra* note 7 at 1436, *discussing Scifo v. Commissioner*, 68 T.C. 714 (1977), *acq.* 1978-2 C.B. 2, where petitioners had excellent records and the court ruled in petitioners' favor, and *Dustin v. Commissioner*, 53 T.C. 491 (1959), *aff'd*, 467 F.2d 42 (9th Cir. 1972), where the court held against a taxpayer that had poor recordkeeping.

[69] *GE Employees Secur. Corp. v. Manning*, 137 F.2d 637 (3d Cir. 1943), *rev'g* 42 F. Supp. 657 (D. N.J. 1941); *Woodward v. United States*, 106 F. Supp. 14 (N.D. Iowa 1952), *aff'd on other grounds*, 208 F.2d 893 (8th Cir. 1953).

[70] *Lawson v. Commissioner*, 42 B.T.A. 1103 (1940); *Hall Paving Co. v. United States*, 338 F. Supp. 670 (D. Ga. 1971), *rev'd on other grounds*, 471 F.2d 261 (5th Cir. 1973).

[71] *Summit Drilling Corp. v. Commissioner*, 5 T.C.M. (CCH) 190 (1946), *aff'd*, 160 F.2d 703 (10th Cir. 1947).

[72] *Christensen v. Commissioner*, 28 T.C.M. (CCH) 594 (1969).

(e) Impact of Insolvency

The insolvency of the debtor, where the market value of total assets is less than the creditors' claims, may, by itself, be an identifiable event. This is especially true if the prospects of recovery appear nil and discovery of this fact occurred suddenly. For example, the discovery of insolvency during an appraiser's report on assets after the creditor had decided to foreclose was held to be an identifiable event.[73] It may be sufficient evidence of insolvency that there are operating losses and the company's finances are so precarious that bondholders can take over to the exclusion of common stockholders.[74] Similarly, where there is considerable doubt as to the company's ability to pay even preferred creditors, or where assets become depreciated due to a sudden disaster, insolvency may emerge as the identifiable event fixing the loss.[75]

Insolvency does not, however, necessarily indicate that the debtor's business has no potential.[76] An insolvent debtor's attempt to reorganize under chapter 11 may indicate that the debtor has expectations of future profit.[77] Also, the possibility of selling the business may indicate a potential for future profits.[78] More important than the insolvency of the debtor is the type of action the debtor is taking to correct the problem that led to the insolvency. Establishing worthlessness may be more difficult in a reorganization under chapter 11 than in a liquidation under chapter 7.

(f) Impact of Liquidation Proceedings

The court in *Morton v. Commissioner*[79] listed bankruptcy and receivership as two events that indicate the end of potential value. In 1938, when this case was decided, reference to bankruptcies most likely referred to liquidations. This case was decided prior to the Chandler Act, which modified the Bankruptcy Act to make reorganizations easier. A chapter 7 petition normally indicates a decision, voluntary or forced by creditors, to "throw in the towel." This decision is often made because additional funds cannot be obtained, the market is weak, inventories cannot be reduced at a reasonable price, or the owners do not want to (or are unable to) invest additional funds in the business. Facts of this nature, along with the filing of a chapter 7 petition and an orderly liquidation of the business under state law, provide considerable evidence to indicate that the potential for the business to have future value has ended. Case law would support the posi-

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[73] *Mattes v. Commissioner,* 1 T.C.M. (CCH) 220 (1942).

[74] *Konta v. Commissioner,* 46 B.T.A. 1280 (1942) (memorandum opinion), *reproduced in full,* 212 Memo. B.T.A. (P-H).

[75] *See Ansley v. Commissioner,* 217 F.2d 252 (3d Cir. 1954), *rev'g* 12 T.C.M. (CCH) 1110 (1953); *Monmouth Plumbing Supply Co. Inc. v. United States,* 4 F. Supp. 349 (D. Fla. 1933).

[76] *See, e.g., Cox v. Commissioner,* 68 F.3d 128 (5th Cir. 1995).

[77] *Lehman v. Commissioner,* 129 F.2d 288 (2d Cir. 1942); *Sipprell v. Commissioner,* 21 T.C.M. (CCH) 491 (1962). *See also Barrett v. Commissioner,* 71 T.C.M. (CCH) 2863 (1966), *aff'd* 1997, U.S. App. LEXIS 3098 (1st Cir. 1997).

[78] *Ainsley Corp. v. Commissioner,* 22 T.C.M. (CCH) 889 (1963), *rev'd,* 332 F.2d 555 (9th Cir. 1964).

[79] See *supra* note 64.

tion that insolvency plus the filing of a chapter 7 or liquidation under state law is a significant event that indicates the worthlessness of the debt and the justification for reporting the loss.[80] However, the taxpayer should always consider all facts to be sure that countervailing evidence does not exist.

(g) Impact of Bankruptcy Reorganization Case or Out-of-Court Settlement

The nature of proceedings under chapters 11, 12, and 13 or of negotiations out of court suggests that the debtor has a chance of rehabilitation; this may suggest that the debt or other security is not worthless.[81]

However, if the status of a creditor or stockholder is such that nothing will be available after secured and priority creditors are compensated, the proceedings may suggest worthlessness of the debt or security.

Going-concern values must be determined to evaluate the potential for future profitable operations.[82] In determining the worthlessness of debt or other securities, courts have looked at the going-concern value and have attempted to value the corporation as a separate, whole entity rather than looking at individual assets.[83]

For business bad debts, bankruptcy is an indication of at least partial worthlessness of securities. Because of the right of stay, bankruptcy reorganization proceedings often preclude the creditor from taking legal action against the debtor, at least for a time period. This generally results in a delay in deducting any amount under I.R.C. section 165, where total worthlessness, a sale or exchange, or other evidence of a completed transaction must occur before the deduction is allowed. Thus, bankruptcy proceedings, rather than providing evidence for a deduction, often delay the reporting of the loss.

An extension of time for payment and/or a change in the interest rates does not give rise to a loss for proceedings in or out of court.[84] If the extension or change in interest rate is accompanied by debt reduction, the loss is recognized.[85] However, if the debt is represented by a security, creditors will lose their bad debt deduction but will probably have an amortizable bond premium.

(h) Other Factors

Events occurring subsequent to the evaluation of a debt reported as worthless are not relevant. The decision about worthlessness must be based on and judged according to conditions existing at the time the initial decision was made. For example, one court stated: "Once it appears from all the surrounding circumstances that a debt has become worthless, we cannot look to subsequent events

[80] *See Young v. Commissioner*, 123 F.2d 597 (2d Cir. 1941).

[81] *See, e.g., Bullard v. United States*, 146 F.2d 386 (2d Cir. 1944).

[82] For a discussion of going-concern values, *see* Newton, *Bankruptcy and Insolvency Accounting: Practice and Procedure* (Hoboken, NJ: Wiley, updated annually), Chapter 11.

[83] *See Ainsley Corp. v. Commissioner*, 332 F.2d 555 (9th Cir. 1964).

[84] *See* Rev. Rul. 73-160, 1973-1 C.B. 365; Rev. Rul. 73-101, 1973-1 C.B. 78.

[85] *See, e.g.,* Rev. Rul. 59-222, 1959-1 C.B. 80.

to determine if a debt in fact becomes worthless. The possibility of collection is tested by the facts known at the time and not by hindsight."[86]

Taxpayers must, however, be careful, after deducting a debt as worthless, not to take actions inconsistent with the decision to write off the debt as worthless. For example, subsequent advances to an insolvent corporation may indicate a belief that it has potential for future profits,[87] and inconsistency between corporate and individual tax returns and financial statements may present problems.[88]

(i) Business Bad Debts (Section 166)

I.R.C. section 166 provides that, for business bad debts, a deduction can be made for debts that are worthless in whole or in part, or a deduction can be made for a reasonable addition to a reserve account. In determining whether a debt is worthless, in whole or in part, Treas. Reg. section 1.166-2(a) states that consideration will be given to all the pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Part (b) of this regulation provides that, when the surrounding circumstances indicate that a debt is worthless and uncollectible and that in all probability legal action would not result in any collection, a presentation of these facts should constitute sufficient evidence for worthlessness of the debt under I.R.C. section 166.

Section 166(a)(1) provides for a deduction for wholly worthless debts, and I.R.C. section 166(a)(2) provides for a deduction for partially worthless bad debts. The partially worthless deduction also requires that the bad debt be charged off within the taxable year. In *Century Motor Coach Inc. v. Commissioner*,[89] the Tax Court disallowed an I.R.C. section 166(a)(1) deduction for a bad debt, on the grounds that the taxpayer had recovered a part of the debt. According to the court, the taxpayer had not relied on I.R.C. section 166(a)(2) (partial worthlessness) for the deduction, and in any event, had not charged the debt off on its books during the taxable year.

Bankruptcy, according to part (c), is generally an indication of worthlessness of at least part of an unsecured or unpreferred debt.[90] The extension of the statute of limitations to 7 years under I.R.C. section 6511(d) also applies to bad-debt losses. *In B.B. Rider Corp. v. Commissioner*,[91] the Third Circuit held that individuals who served as shareholders and officers of a refrigerator sales and service franchise could not claim business bad-debt losses for principal payments on corporate debts that they had personally guaranteed in a bankruptcy reorgani-

[86] *Minneapolis St. Paul and Sault Ste. Marie R. Co. v. United States*, 164 Ct. Cl. 226, 241 (1964).

[87] *Rassieur v. Commissioner*, 129 F.2d 820 (8th Cir. 1942); *Singer v. Commissioner*, 34 T.C.M. (CCH) 337 (1975), *aff'd*, 560 F.2d 196 (5th Cir. 1977). *But see Yeager v. United States*, 58-1 USTC (CCH) 9174 (W.D. Ky. 1957); *George E. Warren Corp. v. United States*, 141 F. Supp. 935 (Ct. Cl. 1956).

[88] *See Scifo v. Commissioner*, 68 T.C. 714 (1977), *acq*. 1978-2 C.B. 2.

[89] 69 T.C.M. (CCH) 2959 (1995).

[90] *See Commissioner v. Levy*, 973 F.2d 265 (4th Cir. 1992) (burden of proving worthlessness remains with the taxpayer/creditor even if the debtor is in bankruptcy proceedings).

[91] 725 F.2d 945 (3d Cir. 1984).

zation, because they did not produce evidence showing that the payments were sufficiently related to preservation of their employment with the corporation. The case also suggested that uncollected interest payments on such debt would be deductible only as nonbusiness bad debts. Following a remand and a subsequent appeal, the Third Circuit[92] held that any interest payments made by the guarantors on debt of a corporation that has been discharged is deductible under I.R.C. section 163 as interest. The court noted that, because the taxpayer had a direct and fixed obligation to pay the notes and had no recourse against the corporation, the interest should be deductible.

In *Lease v. Commissioner*,[93] the Tax Court held that Lease's advances to Montex were contributions to capital, and, even if the advances were debt, the debt was nonbusiness bad debt. Citing *Estate of Mixon v. United States*,[94] the Tax Court noted that, in the absence of regulations, case law controls the issue of whether advances to a corporation are debt or equity. The Tax Court concluded that the advances to Montex were clearly capital contributions rather than debt. The court noted that, when the advances were made, Montex had no capital or assets and had not even begun its operations as a mining business. The taxpayer was relying on an oral promise for capital from an investor with whom he had never previously dealt. The court concluded that no reasonable creditor would have been comfortable making a loan to a corporation without any assets, capital, or contractually committed investors.

Based on *Mixon*, the court concluded that an advance to Montex, even if assumed to be debt, would not qualify as a business bad debt because there was no proximate relationship between Lease's advances and his business activities as an actual or prospective employee. The court found it inconceivable that someone would advance $295,000 to a corporation to secure employment as a corporate officer at a salary of $100,000 per year.

In Baldwin v. Commissioner,[95] Jerry Baldwin and another individual formed a partnership in 1985 to manufacture and sell satellite dish antennas. The business was successful, and Baldwin acquired his partner's interest and incorporated the business as Baldwin Enterprises Inc. (BEI). Baldwin received 150 shares, and three employees of the partnership received a total of 50 shares.

The undistributed earnings were structured as debt rather than equity in BEI. Baldwin's basis in his partnership interest was transferred to BEI as $161,483 unsecured debt and as stock with a basis of $54,820. The unsecured debt was represented by a note that called for the payment of interest, but no payments of interest or principal were ever made. Because of financial problems, most of the employees were laid off and Baldwin claimed a $161,483 bad debt deduction on the Schedule C attached to his 1987 return. The Tax Court held that Baldwin was entitled to the bad debt deduction. The court determined that Baldwin's advance to BEI constituted debt rather than equity. The advances

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[92] *Stratmore v. Commissioner*, 48 T.C.M. (CCH) 1369 (1984) (*on remand from* B. B. Rider, 725 F.2d 945), *rev'd*, 785 F.2d 419 (3d Cir. 1986).
[93] 66 T.C.M. (CCH) 1121 (1993).
[94] 464 F.2d 394 (5th Cir. 1972).
[95] 66 T.C.M. (CCH) 769 (1993).

were found to be reasonable under the circumstances because, as the Tax Court noted, the business had initially realized large profits and Baldwin and his advisers believed that the high level of profits would continue.

The Tax Court held that a settlement payment based on debt guarantee is not deductible as a bad debt.[96] Stephen Scofield, a shareholder, officer, and director of Northeast Cellulose, Inc., signed a guarantee with Guaranty Bank & Trust Co. for a line of credit granted to Northeast. Around the same time, Scofield's financial statements estimated that he had a $1 million interest in Northeast. Later that year, Northeast ceased doing business. The creditors filed a $3 million suit against Scofield. Scofield filed a bankruptcy petition, later settled the lawsuit, and agreed to pay $750,000 for the release of the creditors' claims.

The Tax Court held that Scofield could not deduct as a bad debt the portion of the $750,000 that was attributable to his guarantee, because the guarantee was not proximately related to his trade or business. Rather, the court determined that Scofield wanted capital appreciation from Northeast and not income. The court allowed Scofield to deduct, under section 162, the portion of the settlement not attributable to the guarantee, because it determined that the underlying claims representing that portion originated in Scofield's conduct as a Northeast officer or employee, not as an investor/shareholder.

Funds advanced to the wife's son that were not formalized where no demands for repayment were made were not deductible when the son filed for bankruptcy and received his discharge.[97] The IRS disallowed the loss because the couple could not prove that the amount was a bad debt arising from a debtor-creditor relationship. The Ninth Circuit, in an unpublished per curiam memorandum, affirmed the Tax Court and denied the couple's claimed deduction for a bad debt to their son because the couple failed to prove that a valid debt existed.[98]

(i) Financial Institutions

Banks and other corporations regulated by federal or state authorities maintaining standards regarding the charges for bad debts are allowed to deduct for tax purposes those charge-offs required by such authorities.[99]

(ii) Cash-Basis Taxpayer

A cash-basis taxpayer can deduct losses from bad debts only when an actual cash loss has occurred. Thus, a taxpayer on the cash basis could not deduct the value of services rendered if the recipient is declared bankrupt and is unable to pay for such services.

[96] *Scofield v. Commissioner*, T.C. Memo. 1997-547; 74 T.C.M. (CCH) 1356.
[97] *Kidder v. Commissioner*, T.C. Memo. 1999- 345.
[98] *Kidder, et ux. v. Commissioner*, No. 00- 70444 (9th Cir. Feb. 23, 2001).
[99] Treas. Reg. § 1.166-2(d).

(iii) Worthlessness

For nonbusiness deductions under I.R.C. section 166, it is also necessary to prove that the debt is totally worthless. Treas. Reg. section 1.166-5 states that a loss on a nonbusiness debt will be treated as sustained only if the debt has become totally worthless, and no deduction will be allowed for a nonbusiness debt that is recoverable in part during the taxable year.[100]

An analysis similar to that used for I.R.C. section 165(g) losses is necessary to support the deduction for a nonbusiness bad debt.

§ 9.5 SECURED DEBT

(a) Introduction

The tax consequences associated with a secured debt depend on several factors, including whether (1) the mortgagee is a conventional lender, a vendor who gave a purchase money mortgage obligation in lieu of cash as an accommodation to the buyer, or a party who purchased the mortgage obligation from the original mortgagee; (2) the mortgagor is personally liable; (3) the mortgagee holds the mortgage in connection with a trade or business; and (4) there is a foreclosure, abandonment, or voluntary conveyance.[101]

(b) Foreclosure

If the creditor elects to foreclose on the property, the tax consequences depend to some extent on whether the creditor purchases the property in the foreclosure sale and whether the creditor was the original owner of the property that was sold to the debtor.

(i) Third-Party Purchase

When the property is purchased by a third party, the mortgagee's gain or loss will be the difference between the amount received on the foreclosure (less foreclosure and collection expenses) and the basis in the debt secured by the mortgaged property.[102] When the mortgagee's basis in the obligation is the same as the amount of the obligation, a gain cannot be realized, but interest may be

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[100] *See Coborn v. Commissioner*, T.C. Memo 1998-377, *aff'd without published opinion*, 205 F.3d 1345 (8th Cir. 1999). (Tax Court denied an individual a nonbusiness bad debt deduction for funds he advanced to a corporation in which he was the controlling shareholder. The court concluded that the debt was not wholly worthless in 1988, the year in which the bad debt deduction was claimed, because the corporation continued in existence after 1988, the individual continued searching for a buyer for the stock of the corporation, a new business plan was formulated in 1989, a public offering was made in 1992, and the individual continued to transfer funds to the corporation.)

[101] *See* Handler, "Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee," 31 *Tax L. Rev.* 193 (1976) (comprehensive discussion of the tax consequences of secured debt in out-of-court situations).

[102] Treas. Reg. § 1.166-6(a).

paid.[103] If the basis is less than the amount of the debt, as would be the case when the mortgage was purchased at a discount, a gain could be realized. The loss would be reported in the year of foreclosure if there is no deficiency judgment against the debtor. If there is a deficiency judgment, then the loss would be deductible in the year that the judgment became worthless.[104] In order to write off the amount of the deficiency judgment, the creditor must have proof of unsuccessful attempts to collect the amount due or proof of the debtor's insolvency.

(ii) Nonvendor Purchase: Two-Step Transaction

If a mortgagee who was not the vendor of the mortgaged property purchases the property at a foreclosure sale, the transaction must be analyzed in two steps.[105] First, the mortgagee has a loss to the extent the basis of the debt exceeds the bid price. The loss will usually be a bad-debt loss and will be either an ordinary loss or a capital loss, depending on whether it is a business or nonbusiness loss. Second, a gain or loss will be recognized to the extent the fair market value of the mortgaged property differs from the mortgagee's basis in the mortgage obligation applied to the bid.

Rev. Rul. 72-238[106] contains an example illustrating the computations in the two-step transaction. An individual defaulted on an unpaid obligation of $400X and the bank purchased the property for $250X. The property's fair market value was $300X. The two-step transaction analysis follows:

First Step:	
Bid price	$250X
Less basis in unpaid loan	400X
Gain (loss) realized on collection reported as bad debt deduction	($150X)
Second Step:	
Fair market value	$300X
Less basis applied to bid price	250X
Gain (or loss) realized	$50X

The $150X loss on the collection of the debt through foreclosure would be an ordinary business bad debt loss. Furthermore, because the bank is in the business of lending money, the $50X gain would also be ordinary income. If the mortgagee was not in the business of lending funds, the $50X gain would be reported as a capital gain and, assuming the mortgage was held for more than 6 months, the gain would be long-term. If the IRS could not provide convincing

[103] *Id.* Any accrued interest that is not paid may be reported as part of the deduction if previously reported as income.

[104] Treas. Reg. § 1.166-3(b); *Derby Realty Corp. v. Commissioner*, 35 B.T.A. 335 (1937), *acq.* 1937-1 C.B. 33, *nonacq.* 1937-2 C.B. 8, *acq.* 1938-1 C.B. 9.

[105] Treas. Reg. § 1.166-6(a), (b); Rev. Rul. 72-238, 1972-1 C.B. 65.

[106] 1972-1 C.B. 65.

proof that the market value was $300X, the creditor would report a bad debt loss of $150X and no gain.

Treas. Reg. section 1.166-6(b)(2) provides that the bid price in the foreclosure sale is presumed to be its fair market value unless clear and convincing proof exists to the contrary. Rev. Rul. 72-238 states, however, that the fair market value will be found in excess of the bid price when so determined by qualified appraisers. The difference between the mortgagee's basis and the fair market value is generally considered a capital gain or loss. The IRS also took the position, in this Revenue Ruling, that a mortgage held by a bank was not a capital asset and that, as a result, any gain was ordinary income. In *Community Bank v. Commissioner*,[107] the IRS argued this position but a decision was not reached on this point, because the court determined that the fair market value of the property acquired by Community Bank was the same as the bid price. See § 2.8(c) for a discussion of the impact of foreclosure on the debtor.

(c) Section 1038: Vendor-Mortgagee Reacquisition

In 1964, Congress passed I.R.C. section 1038, which allows a property owner who sold the property, accepted a mortgage as security, and later reacquired the property, to treat the situation as though a sale did not occur. The property must have been secured and reacquired by the original seller. The seller's estate or donee is not able to use this section. Neither a gain nor a loss will result to the mortgagee on the reacquisition of the property, except as provided in I.R.C. sections 1038(b) and (d). Under section 1038(b), the amount of the gain is the lesser of (1) money plus fair value of other property received prior to reacquisition, to the extent this exceeds the gain on the sale previously reported as income (realized gain taxed), or (2) the untaxed gain realized on the sale less costs associated with reacquisition of the property. Note that no reference is made to the fair market value of the property at the time of reacquisition.

The untaxed gain, which is described in the Treasury Regulations as a limitation on the amount of the gain,[108] is the difference between the sale price and the adjusted basis at the time of sale, reduced by the amount of gain returned as income. The limitation does not apply if the selling price of the property is indefinite and cannot be determined at the time of reacquisition.

The Treasury Regulations, in defining the meaning of money and other property with respect to the sale, provide the following:

- Payments made on the property at the time of reacquisition are considered received prior to the reacquisition. For example, if the purchaser gives money or property at the time of reacquisition for partial or complete satisfaction of the debt, the value of these payments will be considered received prior to reacquisition.
- Any amounts received as interest are excluded from the computation of gain on sale and are not considered as money or other property received.

[107] 62 T.C. 503 (1974).
[108] Treas. Reg. § 1.1038-1(c).

- The amount received by discounting the purchaser's indebtedness is the amount received by the seller, except that such amount shall be reduced by the amount paid or the value of property transferred to reacquire the indebtedness. For example, if S sells real property to P for $25,000, and under the contract receives $10,000 down and a note from P for $15,000, S would receive $22,000 with respect to the sale if he were to discount the note for $12,000. If, before the reacquisition of the real property, S were to reacquire the discounted note for $8,000, he would receive $14,000 with respect to the sale.

(i) Nature of Gain

The character of the gain resulting from a reacquisition is determined on the basis of whether the gain on the original sale was reported on the installment method or, if not, on the basis of whether title to the real property was transferred to the purchaser. If title was transferred to the purchaser in a deferred payment sale, the nature of the gain will depend on whether the reconveyance of the property to the seller was voluntary. For example, if the gain on the original sale of the reacquired property was returned on the installment method, the character of the gain on reacquisition by the seller must be determined in accordance with Treas. Reg. section 1.453-9(a). If the original sale was not on the installment method but was a deferred payment sale, as described in Treas. Reg. section 1.453-6(a), where title to the real property was transferred to the purchaser and the seller accepts a voluntary reconveyance of the property, the gain on the reacquisition will be ordinary income. If the obligations satisfied are securities, any gain resulting from the reacquisition will be capital gain.[109]

Thus, the nature of the gain, ordinary or capital, is not affected by I.R.C. section 1038.

Under I.R.C. section 1038(d), any amount previously deducted as a worthless debt, in full or in part, will be considered in the total amount received under section 1038(b), but only to the extent that the deduction resulted in a tax benefit.

(ii) Basis of Property

The basis of real property reacquired in a reacquisition is the sum of:

- The amount of the adjusted basis of the indebtedness of the purchaser that was secured by the property;
- The amount of gain resulting from reacquiring the property;
- The amount of money or other property paid or transferred by the seller in connection with the reacquisition.[110]

The basis of any indebtedness not discharged and secured by the property reacquired is zero.

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[109] Treas. Reg. § 1.1038-1(d).
[110] Treas. Reg. § 1.1038-1(g).

The use of I.R.C. section 1038 is mandatory. This section has the effect of not allowing a loss on the reacquisition of the property even though the property may have declined in value.

The holding period for the reacquired property consists of the holding period prior to the sale plus the period after reacquisition. It does not include the period from sale to reacquisition.

(iii) Examples

Consider the following examples, presented in Treas. Reg. section 1.1038-1(h).

EXAMPLE 9.1

(a) S purchases real property for $70 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract, P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the first $10 annual payment, P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays $5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $50.

(b) The gain derived by S on the reacquisition of the property is $14, determined as follows:

Gain before application of limitation:

Money with respect to the sale received by S prior to the reacquisition	$20
Less: Gain returned by S as income for periods prior to the reacquisition ($20 × [($100 – $70)/$100])	6
Gain before application of limitation	$14

Limitation on amount of gain:

Sale price of real property		$100
Less:		
Adjusted basis of the property at time of sale	$70	
Gain returned by S as income for periods prior to the reacquisition	6	
Amount paid by S in connection with the reacquisition	5	81
Limitation on amount of gain		$19
Gain resulting from the reacquisition of the property		$14

(c) The basis of the reacquired real property at the date of the reacquisition is $75, determined as follows:

Adjusted basis of P's indebtedness to S ($80 – ($80 × $30/$100))	$56
Gain resulting from the reacquisition of the property	14
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	$75

EXAMPLE 9.2

(a) S purchases real property for $20 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract, P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the second $10 annual payment, P defaults and S accepts from P in complete satisfaction of the indebtedness a voluntary reconveyance of the property plus cash in the amount of $20. S does not pay any amount in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $30.

(b) The gain derived by S on the reacquisition of the property is $10:

Gain before application of the limitation:

Money with respect to the sale received by S prior to the reacquisition ($30 + $20)	$50
Less: Gain returned by S as income for periods prior to the reacquisition ($50 × ($100 – $20)/$100)	40
Gain before application of limitation	$10

Limitation on amount of gain:

Sale price of real property		$100
Less:		
Adjusted basis of the property at time of sale	$20	
Gain returned by S as income for periods prior to the reacquisition	40	60
Limitation on amount of gain		$40
Gain resulting from the reacquisition of the property		$10

(c) The basis of the reacquired real property at the date of the reacquisition is $20, determined as follows:

Adjusted basis of P's indebtedness to S ($50 – ($50 × $80/$100))	$10
Gain resulting from the reacquisition of the property	10
Basis of reacquired property	$20

EXAMPLE 9.3

(a) S purchases real property for $80 and sells it to P for $100, the property not being mortgaged at the time of sale. Under the contract, P pays $10 down and executes a note for $90, with stated interest at 6 percent, to be paid in nine annual installments. At the time of sale, P's note has a fair market value of $90. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale. After the third $10 annual payment, P defaults and S forecloses. Under the foreclosure sale, S bids in the property at $70, cancels P's obligation of $60, and pays $10 to P. There are no other amounts paid by S in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is $70.

(b) The gain derived by S on the reacquisition of the property is $0, determined as follows:
Gain before application of the limitation:

Money with respect to the sale received by S prior to the reacquisition		$40
Less: Gain returned by S as income for periods prior to the reacquisition ([$10 + $90] – $80)		20
Gain before application of limitation		$20

Limitation on amount of gain:

Sale price of real property		$100
Less:		
Adjusted basis of the property at the time of sale	$80	
Gain returned by S as income for periods prior to the reacquisition	20	
Amount of money paid by S in connection with the reacquisition	10	110
Limitation on amount of gain (not to be less than zero)		$0
Gain resulting from the reacquisition of the property		$0

(c) The basis of the reacquired real property at the date of the reacquisition is $70, determined as follows:

Adjusted basis of P's indebtedness to S (face value at time of reacquisition)	$60
Gain resulting from the reacquisition of the property	0
Amount of money paid by S on the reacquisition	10
Basis of reacquired property	$70

(d) Voluntary Conveyance and Abandonment

To avoid delay and public disclosure, the mortgagor and mortgagee may agree to an arrangement in which the mortgagor voluntarily transfers the property to the mortgagee in settlement of the debt. The amount of the gain or loss that the mortgagor will be allowed is the difference between the mortgagee's basis in the obligation and the fair market value of the property received, adjusted for the expense of settlement and any accrued interest that was previously reported as income and not collected. The loss is reported as a bad debt deduction, and any gain would first be considered interest income to the extent that any unpaid interest is due but has not been previously reported as income. Any excess would be ordinary income.[111]

If the mortgage obligation is a security within the terms of I.R.C. section 165(g) or is held as a capital asset according to I.R.C. section 1232(a), a capital gain or loss will result from the conveyance.

[111] *See* Handler, *supra* note 101.

If the mortgagor successfully abandons the property, no sale or exchange is deemed to have occurred, and any gain or loss from such action is considered ordinary income or loss. Voluntary abandonment may, however, be considered a sale. In *Abrams v. Commissioner*,[112] property held as a capital asset was voluntarily reconveyed to the seller to avoid foreclosure. The taxpayer called it an abandonment and reported the loss on abandonment as ordinary. The court held that a voluntary abandonment is treated as a sale. For a discussion of the impact of voluntary conveyance and abandonment on the debtor, see 2.8(d).

(i) Debtor Personally Liable

Even after foreclosure, voluntary conveyance, or abandonment, the mortgagee may be unable to declare the unpaid debt as totally worthless if the debtor has any right of redemption or if the mortgagor is personally liable. If it is apparent that the unpaid mortgage obligation is uncollectible, the gain or loss can be recognized.[113] In instances where the mortgagor is personally liable, it may be necessary for the mortgagee to establish uncollectibility of the debt before a deduction will be allowed.

§ 9.6 REORGANIZATION

This section describes the tax consequences to the creditors of a reorganization that qualifies as a tax-free reorganization under I.R.C. section 368(a)(1). The tax-free reorganization is often in the form of a "G" reorganization of a debtor in bankruptcy where a corporation transfers all or part of its assets to another corporation in a plan under "title 11 or similar case" and stock or securities of the transferee corporation are distributed in a transaction that qualifies under I.R.C. sections 354, 355, or 356 or an "E" involving a recapitalization.

(a) Debt for Debt/Stock

The tax consequence to a creditor that exchanged its debt for another debt instrument depends on whether the debtors present a claim that constitutes a security for federal income tax purposes. The determination as to whether the debt constitutes a "security" depends on the facts and circumstances surrounding the origin and nature of the obligation. As a general rule, a debt evidenced by a written instrument with a term of five years or less at the time of issuance or a trade debt does not constitute a security instrument. A debt instrument with a term of ten years or more generally does constitute a security instrument. A debt instrument with a term of more than five and less than ten years may be a security depending on the nature of the instrument.

(i) Debt Not Classified as Security

If the present debt is not classified as a security, the debtor will recognize a gain or loss on the exchange of its present claim for new securities (either stock or

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[112] 42 T.C.M. (CCH) 355 (1981).
[113] Treas. Reg. § 1.166-6(a); *Havemeyer v. Commissioner*, 45 B.T.A. 329 (1941).

debt or both) and other considerations. The gain or loss will be the difference between the value of the new securities and other property, including cash, and the tax basis of the present debt. Any payment that the I.R.C. may interpret as consideration for accrued interest will be taxed as ordinary income unless the interest was previously reported as accrued interest.

(ii) Debt Classified as Security

If the present debt is classified as a security, the creditor will generally not recognize any gain or loss on the exchange of present securities for new securities (stock or debt or both). A gain, but not a loss, will, however, be recognized to the extent that the principal amount of the tax securities exceeds the principal amount of the securities surrendered. A gain will also be recognized to the extent that the consideration received does not constitute a security. The gain recognized will be the difference between the lesser of the cash and other property that is not classified as a security received or the excess of the value of the total consideration (cash, other property, and new securities) over the tax basis of the debt. If a debt classified as a security is received and no debt classified as a security is exchanged for the security, a gain, but not a loss, will be recognized to the extent that the value of the security received exceeds the tax basis of the debt. The receipt of consideration for interest will be taxed as interest income unless previously reported. This interest must be reported by all reorganizations, but is more likely to be a problem in a "G" reorganization.

The tax impact of the gain depends on the classification of the debt. For example, if the security is a capital asset, the gain will be a capital gain. If the security has been held for more than one year, it will be a long-term capital gain.

The tax basis in the securities surrendered will carry as the basis of the acquired securities and the holding period of the prior securities will be added to the holding period of the new securities.

(b) Stock for Stock

The shareholders of the debtor corporation will not generally recognize any gain or loss on the exchange of their stock for new stock of the reorganized entity. Thus, even though the basis in the stock is generally much higher than the value of the stock received, the shareholder is not able to recognize any gain or loss on the exchange. The basis and holding period of the old stock will carry over to the new stock. A gain or loss will be recolonized on disposal of the stock acquired in the reorganization.

If the shareholder does not receive any new stock or other securities as a result of the plan, as has been the case in several chapter 11 cases, a loss will be recognized as of the last day of the taxable year in which the shares became worthless as described in §§ 9.4(c)-9.4(g). It should be recognized that the loss may not necessarily be deductible in the taxable year in which the plan was confirmed without any consideration being given to the shareholder, but would be deductible in any earlier taxable year if it can be shown that the facts indicate that the recovery for shareholders will be nothing.

The tax consequences to the corporation were described in Chapter 5. Appendix G is an example of the tax impact of the plan that was presented in the disclosure statement of Revco.

The Ninth Circuit, reversing the Tax Court, held that shareholders were entitled to a worthless stock deduction for stock canceled in a chapter 11 bankruptcy proceeding in which shareholders received new shares in the reorganized corporation in exchange for contributing additional capital.[114]

The taxpayers acquired their rights in the new corporation not because they owned old shares, but because they submitted a reorganization plan that was approved (over other options) and because they contributed new capital. The court also noted that the fact that the taxpayers participated in formulating the reorganization plan was not a factor in determining whether the old shares had potential value. Several other cases support the worthlessness of the stock.[115] In these cases, new shares were issued pursuant to a plan of reorganization where the original shareholders additionally contributed to the plan or where outsiders were also offered new shares even though they did not own the original shares that were cancelled. Other cases mentioned in Delk are cases that hold the contrary position that notwithstanding the cancellation of the common stock, the stock did not become worthless in that year.[116]

In *In re Steffen*[117], even though the stock was cancelled, it was placed in trust for the shareholders. Because the common shareholders had the potential for distribution under the plan confirmed by the bankruptcy court, the court held that "it cannot be said that the common stock of Bicoastal was rendered valueless simply by virtue of its cancellation, especially in light of the fact that there was a creation of a stock trust." The court further noted that "at a minimum, the facts . . .were complicated and not a straight mom and pop organization that had the common stock canceled upon effectuation of a plan."[118] Thus the shares were not held worthless.

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[114] *Delk v. Commissioner*, 113 F.3d 984 (9th Cir. 1997).

[115] *Brooks v. United States*, 32 F.Supp. 158 (M.D. Pa. 1940); *DeFord v. Comm'r*, 19 B.T.A. 339, 1930; and *Stearns v. Kavanagh*, 29 A.F.T.R. (P-H) 1487 (E.D. Mich. 1941).

[116] *See Coleman v. Comm'r*, 31 B.T.A. 319, 1934 WL 70 (1934), *aff'd*, 81 F.2d 455 (10th Cir. 1936), *Jones v. Comm'r*, 103 F.2d 681 (9th Cir. 1939); *United Gas Improvement Co. v. Comm'r*, 47 B.T.A. 715 (1942), *aff'd*, 142 F.2d 216 (3d Cir. 1944).

[117] *In re Steffen*, 305 B.R. 369 (Bankr. D. Fla., 2004).

[118] *Id.*, at 373-374.

CHAPTER TEN

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§ 10.1 INTRODUCTION

The objective of this chapter and the next is to discuss the aspects of bankruptcy taxation that present special problems associated with the filing of tax returns and the payment and assessment of tax. This chapter contains a review of procedures for filing returns and determining taxes and the jurisdiction of the bankruptcy court.

The provisions of the Bankruptcy Code changed the tax procedures to be followed in a bankruptcy case, and some Internal Revenue Code sections were amended to conform to the provisions of the Bankruptcy Code.

§ 10.2 NOTICE AND FILING REQUIREMENTS

(a) Notice to Governmental Agencies

Pursuant to I.R.C. section 6036, every trustee for a bankrupt estate, court-appointed receiver, assignee for the benefit of creditors, other fiduciary, and executor must give notice of qualification to the Secretary of the Treasury or a delegated representative in the manner and within the time limit required by regulations of the Secretary or delegate.

Prior regulations under section 301.6036-1(a)(1) required receivers, bankruptcy trustees, debtors in possession, and other like fiduciaries in a bankruptcy proceeding to provide the appropriate district director with notice of appointment within 10 days of the date thereof. Notice was not required, however, if it had been given to the Secretary or other Treasury official under any provision of title 11 of the U.S. Code. The amendment to the regulations eliminates the notice requirement under section 6036 for bankruptcy trustees, debtors in possession, and other like fiduciaries in a bankruptcy proceeding. The regulations were amended because the IRS has determined that the notice requirements contained in the Bankruptcy Rules are sufficient for its purposes.

(i) Form of Notice

Where written notice is required, it may be made on Treasury Form 56: Notice Concerning Fiduciary Relationship (see § 10.6 of this chapter) and should include:

- The name and address of the person making such notice and the date of appointment or of taking possession of the assets;
- The name, address, and employer identification number of the debtor or other person whose assets are controlled.
- In the case of a court proceeding, the following additional information may be required in a supplementary schedule:
  - The name and location of the court in which the proceeding is pending;
  - The date on which the proceeding was instituted;
  - The number under which the proceeding is docketed;
  - The date, time, and place of any hearing, meeting of creditors, or other scheduled action with respect to the proceeding.

Similar notices may be required by other governmental taxing authorities and should be filed in accordance with their prescribed procedures.

I.R.C. section 6903 requires that a fiduciary give the Treasury Department a notice of relationship (a statement that any person is acting for another in a fiduciary capacity). This notice is filed on Treasury Form 56. Once this notice has been filed, the trustee would have the right to file or amend prior years' returns and act on behalf of the estate in other tax issues that might arise. Notice given under I.R.C. section 6036 would satisfy the requirement of I.R.C. section 6903.

(ii) Failure to Give Notice

If a required notice is not given as stipulated by I.R.C. section 6036, the period of limitations on the assessment of taxes is suspended from the date the proceeding is instituted to the date notice is received by the District Director and for an additional 30 days thereafter. However, the suspension in no case shall exceed 2 years.[1]

(b) Special Procedures Function

Chapter 11, chapter 12, business chapter 13, and chapter 7 cases with assets are handled by bankruptcy advisers in the IRS's district offices. To facilitate control over the cases pending, the IRS may send a letter to the chapter 11 debtor explaining the returns to be filed, the location where tax returns should be filed, the location where notices should be sent, the procedures to be followed in making tax deposits, the restrictions a tax lien may place on the use of cash collateral, and other relevant information.

§ 10.3 TAX DETERMINATION

(a) Tax Liability

Section 505 of the Bankruptcy Code authorizes the bankruptcy court to determine the tax liability of a debtor, provided the tax issue had not been contested and adjudicated before the commencement of the bankruptcy case. Included would be any fine or penalty relating to a tax or any other addition to a tax.[2] The bankruptcy court determines the tax claims allowed under section 502 of the Bankruptcy Code and the dischargeability of the tax under section 523 of the Bankruptcy Code. Section 505 of the Bankruptcy Code applies to all types of taxes, including income taxes, excise taxes, sales taxes, unemployment compensation taxes, and so on. Once the bankruptcy court has determined the tax liability under section 505, the IRS can assess the tax against the debtor or, if the petition is filed by an individual, against the estate (section 505(c) of the Bankruptcy Code). Collection would be delayed by the automatic stay.

The National Office of the IRS issued a "policy statement" change indicating that it would issue prompt determination letters only on returns for which there is a tax liability. The Service no longer issues determination letters for partnerships and S corporations. However, it is still advisable for the debtor to request such a letter and properly document the request. For example, in *In re First Securities Group of California, Inc.*,[3] the bankruptcy court considered the request valid over the objection of the IRS.

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[1] I.R.C. § 6872; Treas. Reg. § 301.6872-1.
[2] 11 U.S.C. § 505(a)(1).
[3] SIPA No. LA 92-01156 KM (Bankr. C.D. Cal. Oct. 7, 1997).

First Securities Group of California, an S corporation, requested the IRS to determine the tax under section 505(b) for calendar year 1996. The IRS rejected the trustee's request for a prompt determination, stating that the provisions of section 505(b) apply only to returns for which there is a tax liability, and generally, the partnership and S corporation show no tax liability. The IRS argued that the National Office of the IRS has issued a "policy statement" change that it would issue prompt determination letters only on returns for which there is a tax liability. The trustee noted that the IRS policy statements do not have the force and effect of law and are not binding on the bankruptcy court. See *In re Technical Knockout Graphics, Inc.*,[4] where the Bankruptcy Appellate Panel (BAP) held that the bankruptcy court was not bound to apply voluntary-involuntary dichotomy as set forth in the IRS policy statement in determining allocation of tax payments pursuant to section 505 of the Bankruptcy Code. The court reasoned that "holding to the contrary would allow IRS policy statements to limit the exercise of the bankruptcy court's equitable jurisdiction, a result inconsistent with the history and intent of bankruptcy legislation." However, the Ninth Circuit reversed the decision of the BAP and held that the payments are involuntary and the bankruptcy court does not have equitable jurisdiction to order otherwise.

The bankruptcy court in *Securities Group of California* held that the estate had no unpaid tax liability for the calendar year 1996 and that the S corporation and the trustee were discharged from any liability for unpaid federal income taxes for 1996. The court also held that:

> as a result of the Trustee's February 1997 filing of a request for prompt determination pursuant to 11 U.S.C. section 505(b) of the final tax return ("Return") filed by the First Securities Estate for calendar year ending December 31, 1996, and the IRS's failure to notify the Trustee that the Return was subject to audit within 60 days of the prompt determination request, as well as its failure to complete an examination within 180 days of the Trustee's request, the Internal Revenue Service shall be precluded from hereafter auditing the Return.

In one case,[5] the bankruptcy court held that the Tax Court could determine the tax liability. The bankruptcy court, in reaching this decision, concluded that the Tax Court could better immunize the IRS against a potential whipsaw effect by consolidating this case with the taxpayer's related cases. The bankruptcy court established a date on which it would hear the case if either party delayed the proceedings without good cause. Once both parties were ready for trial, the bankruptcy court indicated that it would then modify the automatic stay to permit trial.

Section 505(a) of the Bankruptcy Code provides that the bankruptcy court may determine the tax liability, except in cases where the tax has been previously determined by a "judicial or administrative tribunal of competent jurisdiction" before the filing of the petition. In *In re Doerge*[6] the debtor contended in

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[4] 68 B.R. 463, 466 (Bankr. 9th Cir. 1986).
[5] *In re William Herbert Hunt*, 95 B.R. 442 (Bankr. N.D. Tex. 1989).
[6] 181 B.R. 358 (Bankr. S.D. Ill. 1995).

bankruptcy court that the three-year period for assessment following the filing of his returns for these years had expired before he filed his tax court petition challenging the government's notices of deficiency. As a result, the debtor claimed that "the government was barred from assessing these taxes following the tax court's decision, and the resulting tax liens, which arose by operation of law following such assessment, are void and cannot be enforced against his property in rem." The court noted that a discharge in bankruptcy only relieves a debtor of personal liability for his obligations, as set forth in section 524(a)(2) of the Bankruptcy Code, and does not automatically invalidate liens securing such dischargeable debts. Rather, according to the court, "these liens continue beyond bankruptcy as a charge upon the debtor's property if not disallowed or avoided."[7]

The court noted that section 505(a)(2)(A) of the Bankruptcy Code and the doctrine of res judicata preclude the court from redetermining tax liabilities that were determined in the tax court proceeding. The court then concluded that "[s]ince the debtor cannot question the legality of these taxes based on expiration of the limitations period prior to the tax court proceeding, he is likewise precluded from questioning the validity of the tax liens that arose from the government's timely assessment following entry of the tax court decision." Thus the court concluded, "even though the tax liabilities themselves are dischargeable in bankruptcy, the resulting tax liens are valid and enforceable against the debtor's property in rem."

The bankruptcy court held that it will not determine the tax liability of a chapter 7 debtor while other administrative and legal remedies—not requiring the payment of the tax—remain open.[8] The taxpayer filed a chapter 7 petition and commenced an adversary proceeding against the United States asking the bankruptcy court to determine:

- Amount of his federal tax liability.
- That the liability was dischargeable.
- That the tax lien on his property was invalid.

The court ruled that the fact that the taxpayer's estate had no assets was irrelevant because the bankruptcy court regularly adjudicates lien claims in no-asset cases. The court held that as long as other administrative and legal remedies remained open to challenge the claim, the taxpayer was required to exhaust those remedies, as they were designed specifically to deal with the issues the taxpayer raised. The court noted that if the taxpayer could not get relief elsewhere without paying the tax, the bankruptcy court would hear his case.

The bankruptcy court has the authority to determine tax liability to be assessed against a responsible person for trust fund-type taxes.[9] The taxpayer

[7] *In re Leavell*, 124 B.R. 535, 549 (Bankr. S.D. Ill. 1991); *see also In re Isom*, 901 F.2d 744, 746 (9th Cir. 1990); *In re Dillard*, 118 B.R. 89, 92 (Bankr. N.D. Ill. 1990).

[8] *In re Fyfe*, 186 B.R. 290 (Bankr. N.D. Ga. 1995).

[9] *In re Lyle*, 193 B.R. 750 (Bankr. E.D. N.C. 1995).

filed a chapter 13 petition, and her case was converted to chapter 7. The IRS held a secured claim for $41,300, and it was a no-asset case. The taxpayer commenced an adversary proceeding to determine her liability for a responsible person penalty assessment.

The bankruptcy court held that the taxpayer possessed standing to maintain the adversary proceeding, but the court abstained because determination of the taxpayer's liability would have no effect on the administration of her bankruptcy case. The court explained that no bankruptcy issues were involved, as the taxpayer conceded that the tax debt would be nondischargeable if she were found to be liable. The court noted that a ruling would have no effect on the administration of the no-asset case and that the taxpayer could challenge her liability for the taxes administratively and in district court.

The bankruptcy court held that the debtor in a chapter 7 case lacks standing to object to creditor claims or to compel the trustee to object to a proof of claim.[10]

The bankruptcy court may determine the existence and amount of an alleged settlement with the IRS. In *In re Latham Exploration Co., Inc.,*[11] where the trustee in bankruptcy claimed that the IRS's tax claim against the company was compromised to $85,000 and the transcript of the hearing could not be found, the bankruptcy court ruled that the right of the trustee to object to the IRS's claim still exists, as do the rights to plead compromise and settlement. The court ordered the trustee to file an adversary proceeding objecting to the IRS's claim and to pay the alleged settlement amount to the registry of the court. The Eleventh Circuit held that the bankruptcy court lacked jurisdiction to determine the withholding tax liability.

The bankruptcy court does not have jurisdiction to determine the tax liability of entities other than the debtor.[12] In *Brandt-Airflex,* the issue dealt with whether the bankruptcy court could determine the liability of Long Island Trust for trust fund taxes Brandt did not pay.

Brandt made an agreement with the Long Island Trust Company to allow overdrafts on its account for preapproved checks. During 1983, 1984, and the first quarter of 1985, Long Island Trust advanced funds to Brandt to pay employee wages, but did not provide funds for federal and New York State withholding taxes. In February 1985, Brandt filed a chapter 11 petition. The IRS and the State of New York filed claims against the bankrupt estate for the unpaid taxes.

Brandt sued in bankruptcy court, contending that it was not liable for the withholding taxes because under I.R.C. section 3505(b) the tax liability for withholding taxes was shifted to Long Island Trust. The bankruptcy court found that Long Island Trust "was a direct cause of the tax accrual" and that the IRS and New York State would "not be prejudiced by proceeding to collect taxes from Long Island Trust." The District Court reversed the decision of the bankruptcy

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[10] *In re Edward R. Fitzsimmons*, No. 4-80-02300 HN (Bankr. N.D. Cal. Apr. 29, 1996).

[11] 83 B.R. 423 (W.D. La. 1988).

[12] *United States v. Huckabee Auto Co.*, 783 F.2d 1546 (11th Cir. 1986); *Brandt-Airflex v. Long Island Trust Co.*, 843 F.2d 90 (2d Cir. 1988).

court on the ground that Brandt had failed to state a claim for relief under I.R.C. section 3505. The circuit court ruled that, although the party supplying funds may be liable, the primary source for the withholding tax liability is the employer.

In *In re Ralph C. McAuley,*[13] the district court reversed the bankruptcy court, which had held that it had the jurisdiction to determine the tax liability of a husband and wife even though only the husband had filed the petition. The bankruptcy court found that the wife is an indispensable party. However, the bankruptcy court dismissed the part of the wife's suit that sought to hold the alleged tax liability of the wife dischargeable and would not enjoin the IRS from assessing and collecting the tax. The bankruptcy court noted that the couple could amend the petition to include the wife.

The bankruptcy court relied on the bankruptcy court's decision in the *Brandt-Airflex* case, described above, which was subsequently reversed by the district court and upheld by the Second Circuit. The district court, in reversing the bankruptcy court, noted that all courts that have considered this issue recently have concluded that section 505(a) of the Bankruptcy Code does not extend the bankruptcy court's jurisdiction to parties other than the debtor.

In *Kroh v. Commissioner,*[14] the Tax Court held that the IRS is not barred from proceeding against the spouse for a tax liability on a previously filed joint tax return where the bankrupt spouse settled the tax liability.

The Tax Court rejected the taxpayer's argument that the IRS's settlement with her husband, and the subsequent assessment and collection of that amount, barred the IRS as a matter of law from litigating her tax liabilities. Citing I.R.C. section 6013(d)(3), the court noted that the tax liability of a husband and wife who file a joint return is joint and several and that common-law rules apply. The court concluded that Kroh's position was analogous to that of the taxpayer in *Dolan v. Commissioner,*[15] where the court held that a prior assessment against an individual does not have the effect of reducing a deficiency determined against the individual's spouse merely because the two filed joint returns.

Kroh's contention that the IRS was barred from litigating her tax liabilities by the doctrines of *res judicata* or collateral estoppel was rejected by the court. The court concluded that tax claims against Kroh and her husband were two separate causes of action and Kroh was not a party or privy of her husband in the bankruptcy court. In addition to *Dolan,* the court cited *Tavery v. United States.*[16] The court also held that collateral estoppel did not apply because there had been no adjudication on the merits of the IRS claim against Kroh's husband, but only a settlement agreement approved by the bankruptcy court.

This was a reviewed opinion and two judges in dissent noted that the doctrine of *res judicata* applied to the Tax Court proceeding. As a result, the IRS was precluded from litigating Kroh's tax liability. The principle that the liability for

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[13] 101 B.R. 306 (Bankr. M.D. Fla. 1989), *rev'g* 86 B.R. 695 (M.D. Fla. 1988).

[14] 98 T.C. 383 (1992).

[15] 44 T.C. 420 (1965).

[16] 897 F.2d 1032 (10th Cir. 1990).

tax for a particular year constitutes a single cause of action is not altered by the fact that a husband and wife who file a joint return are considered two separate and distinct taxpayers. It was also noted that neither *Dolan* nor *Tavery* supports the result reached by the majority.

Tax claims that are determined by a bankruptcy court in a dismissed case may not be relitigated in the Tax Court. In *Florida Peach Corporation v. Commissioner*,[17] the taxpayer filed a chapter 11 bankruptcy petition on March 11, 1980. The IRS filed a proof of claim for the corporate income tax liabilities for taxable years ending March 31, 1974, through March 31, 1977. On February 8, 1982, the bankruptcy court entered judgment, dismissing Florida Peach's objections to the IRS's claim and allowing the government's income tax claim in full. On February 22, 1982, the bankruptcy court dismissed the bankruptcy case, and the automatic stay against asserting tax liabilities was lifted. After the bankruptcy case was dismissed, Florida Peach filed a Tax Court petition.

The IRS then filed a motion for summary judgment, claiming that the doctrine of *res judicata* barred Florida Peach from relitigating the tax liabilities determined by the bankruptcy court. The Tax Court held that *res judicata* bars Florida Peach from relitigating the tax liabilities previously allowed by the bankruptcy court. The bankruptcy court had authority to decide the tax claims asserted, and the judgment of the bankruptcy court was final and appealable. Also, the Tax Court stated that the bankruptcy court's judgment on the tax liability was not vacated by the subsequent dismissal of the bankruptcy case because section 349(b)(2) of the Bankruptcy Code does not "undo" all judgments, but only those rendered under provisions enumerated in section 349(b)(2). In *Samuel Leroy Bostian v. Commissioner*,[18] it was also held that the bankruptcy court determination of taxes is valid even if the case is dismissed.

In *In the matter of East Coast Brokers & Packers*,[19] the bankruptcy court held that the state statute of limitations does not bar the debtor's objection to state tax claims. East Coast Brokers & Packers, Inc. (ECBP) filed a chapter 11 petition in June 1989. In November 1989, the state of Florida filed a claim for ad valorem tangible personal property taxes which were certified for collection in October 1989. In July 1991, ECBP filed an objection in the bankruptcy court to the tax claim filed by the state of Florida. The state moved to dismiss ECBP's objection, claiming that the bankruptcy court is barred from ruling by section 194.171(2) of the Florida Statutes. The Florida law provides that no action may be brought to contest a tax assessment after 60 days from the date the assessment is certified for collection.

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[17] 90 T.C. 678 (1988).

[18] 62 T.C.M. (CCH) 1337 (1991).

[19] 142 B.R. 499 (Bankr. M.D. Fla. 1992); *See City Vending of Muskogee, Inc.*, 898 F.2d 122 (10th Cir. 1990); *In re Quattrone Accountants, Inc.*, 895 F.2d 921 (3rd Cir. 1990); *In re Washington Manufacturing Co.*, 120 B.R. 918 (Bankr. M.D. Tenn. 1990); *In re Palm Beach Resort Properties, Inc.*, 51 B.R. 363 (Bankr. S.D. Fla. 1985); and *Tapp v. Fairbanks North Star Borough (In re Tapp)*, 16 Bankr. 315 (Bankr. D. Alaska 1981).

The bankruptcy court held that the bankruptcy court has the authority and jurisdiction under section 505 of the Bankruptcy Code to consider ECBP's objection and that section 505(a)(2) does not interfere with the bankruptcy court's authority to consider the matter, because the liability was not previously contested or adjudicated by another tribunal.

Several other courts have followed *East Coast Brokers & Packers*, and the other cases that allowed the hearing on the tax issues involved a determination of an unpaid tax liability, rather than a request for a refund. Some courts have been reluctant to extend the time period for a refund under section 505(a)(2)(B).[20]

Once the plan has been confirmed, it is generally difficult to convince the court to consider other issues, including the issue related to the determination of taxes. For example, in the case of *In re Wayne C. Callan*,[21] Wayne and Carol Callan filed a motion on January 6, 1992, pursuant to section 505 of the Bankruptcy Code, for a determination that they are entitled to a postconfirmation federal tax refund.

The Callans filed a chapter 11 petition on May 6, 1987, and their plan was confirmed on February 27, 1989. The property of the estate revested in the Callans upon confirmation of the plan as provided by section 1141(b) of the Bankruptcy Code. The Callans applied to the IRS for a claim for refund and request for abatement of taxes paid for heating fuel oil for the periods from January 1, 1990, to September 18, 1990, for $58,944.40. Prior to 1990, the Callans had purchased heating fuel oil from a wholesale vendor for resale to the final consumers and had previously received the refund of the federal fuel tax and did not pass the tax burden to the ultimate consumer. A change in the tax required the request for refund to be made by the end user.

The Callans argued that the inability to use the $58,944.40 from 1990 fuel taxes which they had expected as a refund hindered them in making their final plan payment. While the tax refunds were not specifically mentioned in the plan as a source of funding the reorganization plan, the plan could have been developed on the assumption that the problem had not even been foreseen by the Callans.

The IRS defended both on the merits and on the ground that the court does not have jurisdiction. The jurisdictional argument is based on the premise that the portion of section 505 of the Bankruptcy Code dealing with refunds refers to a refund by a "trustee." The term "trustee" no longer applied to the Callans, according to the argument of the IRS, because the plan had been confirmed and they were no longer debtors-in-possession. The court did not rule on the merits of the tax matter, but agreed that sovereign immunity is not waived in a contested proceeding involving postconfirmation taxes that are not specifically alluded to in the confirmed plan.

The bankruptcy court noted that the U.S. Supreme Court recently held that "a waiver of federal sovereign immunity must be found in the statute itself. It is

[20] *See Penking Trust V. Sullivan County*, 196 B.R. 389, 402 (Bankr. D. Tenn. 1996) and *In re Cumberland Farms Inc*. 175 B.R. 138 (Bankr. D. Mass. 1994).

[21] No. 3-87-00369-HAR (Bankr. D. Alaska 1992).

immaterial that there may be legislative history supporting a congressional intent for the federal waiver of sovereign immunity which might explain an imprecise statute."[22]

The bankruptcy court held that "the taxes do not come from operations under the estate" but with respect to activities of the postconfirmation or reorganized debtors. The trustee or debtor-in-possession is not seeking the refund. The Callans are no longer chapter 11 debtors-in-possession, akin to trustees for many purposes, as indicated in section 1107 of the Bankruptcy Code. The court held that no waiver for a refund is granted for a reorganized debtor, and, under *Nordic Village,* none can be presumed.

The court also noted that, when a debtor confirms a chapter 11 plan, it should begin cutting the ties with the bankruptcy process at the same time.[23]

A debtor was allowed to pursue his tax claim in a reopened chapter 7 case.[24] In the reopened chapter 7 filing, the debtor filed an amended tax return for 1987, asserting that business debt forgiven, reported by the trustee as income, was not taxable income under I.R.C. section 108. The Third Circuit, reversing a district court, held that a chapter 7 debtor had standing to pursue his tax claim. The Third Circuit rejected the Service's assertion that only the bankruptcy trustee could sue for refund because the debtor had failed to schedule the tax claim explicitly as an asset of the estate, and that any refund granted to the debtor was therefore erroneous and could be recovered. The Third Circuit noted that the debtor could not have scheduled the tax refund separately at the time of his bankruptcy filing, because the refund was not yet a known asset. According to the Third Circuit, the IRS could not prevail, because it took no position in the district court on the underlying validity of the refund. The court suggested that the debtor "must consider himself the fortunate beneficiary of the litigation strategy" followed by the Service.

In *In re Brulotte,*[25] the bankruptcy court sustained the objection made by Richard and Sandra Brulotte to the IRS's proof of claim for $34,000. The Brulottes objected to the claim, alleging that their tax debt had been satisfied when they surrendered the equipment from their failed tavern to the IRS, which sold the property. On appeal, the Ninth Circuit BAP reversed, ruling that the testimony was inadmissible and that there was insufficient other evidence to establish that the Brulottes had satisfied their tax liability.

The Brulottes appealed to the Ninth Circuit, and the decision was again reversed. The Ninth Circuit found sufficient evidence to support the factual

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[22] *United States v. Nordic Village*, 112 S. Ct. 1011 (1992).

[23] *Pettibone Corp. v. Easley*, 935 F.2d 120, 122 (7th Cir. 1991). *See In re Xonics, Inc.*, 813 F.2d 127, 130—32 (7th Cir. 1987); *In re Chicago, Rock Island & Pacific R.R.*, 794 F.2d 1182, 1186-87 (7th Cir. 1986). *See also Pacor, Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984); *Goodman v. Phillip R. Curtis Enterprises, Inc.*, 809 F.2d 228, 232-33 (4th Cir. 1987); *National City Bank v. Coopers & Lybrand*, 802 F.2d 990, 994 (8th Cir. 1986); *In re Gardner*, 913 F.2d 1515, 1518-19 (10th Cir. 1990).

[24] *Hutchins v. IRS*, 67 F.3d 40 (3d Cir. 1995).

[25] 1993 U.S. App. LEXIS 34208; 73 A.F.T.R.2d (RIA) 882; 15 F.3d 1083 (9th Cir. 1993).

finding of the bankruptcy court that the Brulottes had paid off their tax debt by turning over the restaurant equipment to the IRS. The Ninth Circuit noted that the bankruptcy court was free to credit the Brulottes' testimony, especially in light of the absence of contradicting evidence.

As a general rule, the bankruptcy court does not determine the amount or the dischargeability of a tax claim in "no-asset" cases.[26] However, the failure of the bankruptcy court to rule on tax issues of no-asset cases involving individuals can place a burden on the individual. To pursue the tax issue in the district courts or Claims Court, the taxpayer must pay the tax and then sue for a refund. Often the deadline for taking action in the Tax Court passes and no funds are available to make the payment; thus, the only avenue for determination of the tax is in the bankruptcy court. Because of this situation, bankruptcy courts have decided to rule on the issues in deserving cases, often over the objection of the IRS or other taxing authorities. For example, in *In re Anderson*,[27] the court noted that "the issue simply is whether or not this Debtor owes the tax liability that has been assessed—not whether it should be litigated in another court."[28]

The Bankruptcy Appellate Panel[29] held that the debtor could not use section 502(c) of the Bankruptcy Code to estimate a postpetition administrative tax claim, because that section only applies to prepetition claims. The court found that proper statutory construction requires administrative tax liability be determined under section 505.The BAP therefore reversed the bankruptcy court's cap on the amount of tax liability. The BAP also determined that the appeal was not moot simply because the Service did not obtain a stay pending appeal and the receiver had distributed the assets of the bankruptcy estate.

A U.S. district court[30] has denied the government's request to prosecute its lien priority case against a health care finance company in district court rather than in bankruptcy court on the basis that no substantial and material consideration of nonbankruptcy law was necessary. Additionally the district court noted that bankruptcy court was familiar with the case.

(b) Proof of Claim

Section 501 of the Bankruptcy Code permits a creditor or indentured trustee to file a proof of claim and an equity holder to file a proof of interest. If the taxing

[26] *See, e.g., Cohen v. United States*, 115 F.2d 505 (1st Cir. 1940); *In re Byerly*, 154 B.R. 718 (Bankr. S.D. Ind. 1992); *In re Millsaps*, 133 B.R. 547 (Bankr. M.D. Fla. 1991); *In re Diez*, 45 B.R. 137 (Bankr. S.D. Fla. 1984); *In re Onondaga Plaza Maintenance Co*., 206 B.R. 653, (Bankr. N.D.N.Y. 1997); *In re G-I Holdings Inc*., 2003 U.S. Dist. LEXIS 16317 (D.N.J. 2003): *In re Pelullo*, 2004 Bankr. LEXIS 243 (Bankr. E.D. Pa. 2004) *In re Bissett*, 1999 Bankr. LEXIS 1462 (Bankr. E.D. Pa. Nov. 29, 1999).

[27] 171 B.R. 549 (Bankr. W.D. Va. 1994).

[28] For additional discussion of the determination of tax in "no asset" cases, see Report of the ABA Tax Section Task Force on the Tax Recommendations of the National Bankruptcy Review Commission 153-55 (1997).

[29] *In re Indian Motocycle Co.,* 259 B.R. 458 (Bankr. 1st Cir. 2001).

[30] *In re Numed Healthcare Inc.,*, No. 2001 U.S. Dist. LEXIS 19264 (M.D. Fla. Oct. 12, 2001).

authority does not file a proof of claim, the debtor, trustee, or any other party who may be liable for the taxes may file a return for the taxing authority. However, if the creditor subsequently files a proof of claim, it supersedes the one filed by another party on behalf of such creditor.

(i) Filing Requirements

Bankruptcy Rule 3002 provides that an unsecured creditor or an equity holder must file a proof of claim or interest for the claim or interest to be allowed in a chapter 7 or chapter 13 case. For the claim to be allowed under section 502 or 506(d) of the Bankruptcy Code, a secured creditor needs to file a proof of claim, unless a party in interest requests a determination and allowance or disallowance. In a chapter 7 or chapter 13 case, a proof of claim is to be filed within 90 days after the date set for the meeting of creditors under section 341(a) of the Bankruptcy Code. For cause, the court may extend this period and will then fix the time period for the filing of a proof of a claim arising from the rejection of an executory contract. The filing of the proof of claim is not mandatory in a chapter 9 or chapter 11 case, provided the claim is listed in the schedule of liabilities. However, if the claim is not scheduled or the creditor disputes the claim, a proof of claim should be filed. It is generally advisable to file a proof of claim even though the claim is scheduled (see Bankruptcy Rule 3003). A proof of claim filed will supersede any scheduling of that claim in accordance with section 521(1) of the Bankruptcy Code.

According to Bankruptcy Rule 1019(4), claims that are filed in a superseded case are deemed filed in a chapter 7 case. Thus, in a case that is converted from a chapter 11 to a chapter 7 case, it will not be necessary for the creditor to file a proof of claim in the chapter 7 case if one was filed in the chapter 11 case. However, if the debt was listed on the schedules in a chapter 11 case and a proof of claim was not filed, it will be necessary to file a proof of claim if the case is converted to chapter 7.

A district court would not allow a challenge to a proof of claim filed by the IRS solely for delinquent child support but rather held that the couple must challenge that claim in state (Nebraska) court.[31]

(ii) Timely Filed Proof of Claim

The general rule is that a creditor in chapter 7 or chapter 13 must file a proof of claim within 90 days after the first date set for the meeting of creditors under section 341 of the Bankruptcy Code. However, the time period of the filing of a proof of claim by a governmental unit is different. The Bankruptcy Reform Act of 1994 amended section 502(b) of the Bankruptcy Code to provide that a claim of a governmental unit, including tax claims, will be considered timely filed if it is filed before 180 days after the order for relief or such later time as the Federal Rules of Bankruptcy may provide. The Act also provides that a proof of claim not timely filed, except for the government claim mentioned above and tardy

[31] *In re Weber*, 215 B.R. 887 (D. Kan. 1997); *aff'd* 1999 U.S. App. LEXIS 6304 (10th Cir. 1999).

claims permitted under section 726 of the Bankruptcy Code, will not be allowed. These changes are effective for petitions filed after October 22, 1994.

As a general rule, late filed proof of claims may be allowed either as amendments under Fed.R. Bankr. P. 7015 or pursuant to the bankruptcy court's exercise of equitable discretion under section 105 of the Bankruptcy Code. In *In re Pettibone Corp.*[32] the bankruptcy court considered the following items set forth in the Seventh Circuit[33] in deciding if the claim should be allowed:

- Whether the debtors and creditors rely on the Government's earlier proofs of claim or whether they instead have reason to know that subsequent proofs of claim would follow on completion of audit
- Whether the other creditors would receive a windfall to which they are not entitled, on the merits, by the court not allowing this amendment to the IRS's proof of claim
- Whether the IRS intentionally or negligently delays in filing the proof of claim stating the amount of taxes due
- The justification, if any, for the failure of the IRS to file for a time extension for the submission of further proofs of claim pending an audit
- Whether there are any other considerations that should be taken into account in assuring a just and equitable result.

The court concluded that because the debtor had been aware of the possibility that the IRS might increase the amount of its timely-filed claim because of an ongoing examination, the court increased the time period for the IRS to file its claims even though the bar date had passed.

A district court has affirmed a bankruptcy court decision disallowing the government's proof of claim on the basis that it was not timely filed, ruling that the lower court properly declined to equitably toll the 180-day period in Bankruptcy Rule 3002(c)(1).[34] Because the government had not alleged that any outside action prevented it from filing its claim or that the taxpayer or the bankruptcy court negligently misinformed it of the filing deadline, the district court noted that the government should have requested additional time to file its claim and that it cannot cry foul for its own inexcusable neglect.

In a chapter 12 case, proper notice was sent listing the creditor based on an Illinois state court judgment and notifying the creditor of the deadline for filing the proof of claim. The creditor allowed the date to pass without filing a proof of claim. Eleven months later the bankruptcy court allowed the creditor to file its late claim. The district court reversed and the Seventh Circuit affirmed the district court's decision on the basis that the late claim was statutorily barred.[35]

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[32] 151 B.R. 156 (N.D. Ill. 1992).
[33] *In re Unroe*, 937 F.2d 346 (7th Cir. 1991); *see In Re International Horizons, Inc.*, 751 F.2d 1213, 1216 (11th Cir. 1985).
[34] *In re Hambright*, 216 B.R. 781 (W.D. Mich. 1997).
[35] *In re Greenig*, 152 F.3d 831 (7th Cir. 1998)

Employment taxes were owed to the Employment Division of the Department of Human Resources of Oregon that was notified by the bankruptcy court that a bankruptcy petition had been filed but that the debtor had not registered with the agency as required by law. After the deadline, the agency filed a proof of claim. The court indicated the fact that the creditor was not aware of the nature of the claim or that they had one was not determinative. The tax claim was subordinated because the claim was untimely filed when creditor had notice of the bankruptcy even though it was unaware of the nature of its claim against the debtor.[36]

In *In the matter of Eddie Burrell,*[37] the taxpayer filed a chapter 13 bankruptcy petition on November 18, 1985. The meeting of the creditors was first set for December 19, 1985. The IRS mailed the taxpayer a deficiency notice on December 30, 1985, for the years 1979 through 1981. The notice was not filed with the bankruptcy court and did not refer to the chapter 13 petition. The IRS filed a proof of claim with the bankruptcy court on April 30, 1986, and an amended proof of claim on June 20, 1986. A second amended proof of claim was filed on March 11, 1987. The taxpayer objected to the IRS's claim on the ground that the IRS's initial proof of claim was not timely filed. In response, the IRS claimed that part of the tax liability is a secured claim and that secured creditors are not required to file a proof of claim in a chapter 13 case. The IRS then argued that the deficiency notice sent to the taxpayer constituted a timely "informal proof of claim." Thus, once the proof of claim was filed, it could be amended with a formal proof of claim filed after the bar date. The bankruptcy court held that the deficiency notice did not constitute a proof of claim and that a proof of claim need not be filed for the secured debt. The court cited *In re Simmons*[38] for the general rule that the filing of a proof of claim is not required by a creditor asserting a secured claim. In *In re Leightner*,[39] the bankruptcy court held in a chapter 13 case that an unsecured claim should be disallowed when filed late.

In *In re Hausladen*,[40] the bankruptcy court held that late-filed, unsecured claims should not be disallowed, interpreting the bankruptcy rules as simply determining whether claims are timely or late, rather than whether they should be allowed or disallowed.

(iii) Amended Proof of Claim

The IRS has been allowed to file an amendment to a proof of claim even if the bar date has passed, provided the original proof of claim was timely filed in certain situations. In *In re Homer R. Birchfield,*[41] the court allowed the IRS to file an amended proof of claim to reflect an agreement reached with the trustee.

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[36] *In re Kragness*, 82 B.R. 553 (Bankr. D. Oreg. 1988).
[37] 85 B.R. 799 (Bankr. N.D. Ill. 1988).
[38] 765 F.2d 547 (5th Cir. 1985).
[39] 161 B.R. 60 (Bankr. D. Or. 1993). *See In re Bailey*, 151 B.R. 28 (Bankr. N.D.N.Y. 1993).
[40] 146 B.R. 557 (Bankr. D. Minn. 1992) (en banc).
[41] No. 5-87-00259; LEXIS, 88 TNT 107-19 (Bankr. W.D. Va. 1988).

Generally, the IRS has not been allowed to amend a proof of claim to include years that were not contained in the original proof of claim. For example, in *United States v. Howard E. Owens*,[42] the District Court upheld the bankruptcy court's decision that would not allow a proof of claim file in a chapter 13 case for 1983 to include the amount due for 1981 even though the tax return for 1981 was filed after the bar date. The bankruptcy court cited three factors it considered: (1) the absolute nature of the policy barring late filings, (2) the failure of the IRS to ask for an extension, and (3) the equitable factors enunciated in *In re Miss Glamour Coat Co., Inc.*[43] The court emphasized, however, that the first two factors alone were enough to justify the preclusion of the 1981 claim.

Courts continue to disallow amended proofs of claim that are filed after the bar date for years not included in original proofs of claim. In *United States v. Roberson*,[44] the district court affirmed a bankruptcy court's decision disallowing an untimely amended proof of claim filed by the IRS. The IRS filed a timely proof of claim for the taxpayers' 1989 income taxes and notified the taxpayers before the bar date that it was auditing their 1991 return. After the time for filing had expired, the IRS advised the taxpayers that they owed taxes and penalties for 1991. More than six months after the chapter 13 plan had been confirmed, the IRS filed an amended proof of claim for the 1991 taxes. The court held that the additional tax claims were not timely and that the proof of claim could not be considered as an amended proof of claim since the tax claim was for a year other than the year relating to the original proofs of claim. The court found support for its position in the Seventh Circuit's decision in *In re Unroe.*[45]

However, the bankruptcy court reached a different decision in In *In re Roderick.*[46] The bankruptcy court allowed an amended claim filed after the bar date to be filed and held that the IRS was entitled to distribution as a timely filed claim, even though the proof of claim was for only one tax year and the amended proof of claims was for three years. The court held that the amended claim related back to the IRS's timely filed claim. The bankruptcy court cited rule 15(c)(2) of the Federal Rules of Civil Procedure and noted that the original claim and the amended claim all related to income taxes. The court also noted that the delay by the IRS was not undue because the bankruptcy trustee knew that the IRS had asserted a claim for taxes for the years for which a return had not been filed, and the trustee suffered no prejudice.

Additionally, the IRS may not be allowed to amend the proof of claim if it is materially greater than the amount reflected in the original proof of claim. For

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[42] 84 B.R. 361 (E.D. Pa. 1988). *See In re William D. Rains*, 139 B.R. 158 (Bankr. D. Md. 1992). (Proof of claim was not timely filed because it was not in the same nature as the initial claim and that the claim for $40,000 was not reasonably within the amount of the timely filed claim of $13,000). *See also In re AM Intern., Inc.*, 67 B.R. 79 (N.D. Ill. 1986).

[43] 80-2 USTC (CCH) ¶ 9737 (S.D.N.Y. 1980).

[44] 188 B.R. 364 (D. Md. 1995).

[45] 937 F.2d 346 (7th Cir. 1991).

[46] No. 387-00294-P7 (Bankr. D. Or. Sept. 8, 1993).

example, in *In the matter of Emil Stavriotis*,[47] the Seventh Circuit would not allow the IRS to amend the proof of claim for 1981 and 1984 income taxes, which had been filed for $11,133. After completing an audit of the 1981 taxes, the IRS attempted to amend the return to over $2.4 million. The Seventh Circuit, in a divided decision, noted that the disposition of the motion to amend a proof of claim rests with the bankruptcy court and found equitable reasons to deny the amendment, including prejudice to other creditors that had no notice of the IRS's audit and the justification for the government's delay.

However, the bankruptcy court held that the Service's amended proofs of claim, filed after the bar date, were not time-barred where the increase in the amount of the claims was not so dramatic as to surprise the debtor.[48] In 1998, the IRS filed a timely proof of claim for a $25,200 section 6672 penalty. Two years later, the IRS filed an amended proof of claim for a $160,000 section 6672 penalty and $55,600 in income taxes. The taxpayer, Jackson, objected, arguing that the amended claims were new claims that should not be allowed. The bankruptcy court distinguished *In re Stavriotis*[49] because the court concluded that the difference in dollar amounts in the Service's earlier and later claims would not result in surprise to Jackson. The court reasoned that Jackson was aware of the company's tax liabilities and that the same circumstances of nonpayment of withholding taxes led to the original and amended claims. Thus, the claim was allowed for equitable reasons because Jackson had knowledge of the potential claim.

The bankruptcy court held that the IRS may not amend, after the bar date, a proof of claim that was an unjustified estimate of the claim. The IRS filed a proof of claim for unpaid federal income taxes in *In re S.T. Patrick*, a chapter 11 case.[50] S.T. and N. Patricia Patrick entered an objection, claiming the amount was too great. After the court sustained their objection, the IRS entered another claim. The bankruptcy court held that the claim should be disallowed on the basis of estoppel. The IRS failed to indicate on its original claim that the claim was merely an estimate. The court noted that it did not "ever inform the debtor that it would be asserting a much more significant claim."[51]

(iv) Failure to Respond to Objection

The IRS may find that the claim has been disallowed after it fails to respond to an objection to the claim, as the bankruptcy court ruled in *In re Hunt Brothers Construction, Inc.*[52] The taxpayer filed a chapter 11 petition and the IRS filed a timely proof of claim and later amended it. After the amendment to the proof of claim was filed, the debtor converted the case to chapter 7 in December 1982. In July 1984, the IRS amended its claim again. In August 1987, the trustee of the chapter 7 case objected to the government's claim and the IRS did not respond to

[47] 977 F.2d 1202 (7th Cir. 1992).
[48] *In re Jackson*, 220 B.R. 273 (Bankr. W.D. Va. 1998).
[49] 977 F.2d 1202 (7th Cir. 1992).
[50] *In re S.T. Patrick*, 96 B.R. 358 (Bankr. M.D. Fla. 1989).
[51] *Id.* at 359.
[52] 1989 Bankr. LEXIS 2022 (Bankr. D. Idaho 1989).

the objection. Because the IRS did not respond to the objection, the trustee sought an order disallowing the claim on October 1, 1987.

On July 1, 1988, the government attempted to amend its claim based on several factors. It argued that the disallowance was void because the trustee used a preprinted objection form rather than making a motion, that notice of the disallowance was not received, that the disallowance order was invalid because it was signed by a clerk rather than a judge, and that the trustee had not affirmatively rebutted its claim. The bankruptcy court, in upholding the court's disallowance of the government's claim, concluded that the preprinted form provided all the information needed, that the form also served as a motion, and that the form provided notice to the government. The court also concluded that the clerk was exercising his authority under a "general order" of the bankruptcy court. According to the court, the trustee was not required to prove the claim was invalid; the IRS had the burden of responding to the trustee's objections and substantiating its claim.

If the tax authority files a tax claim that is different from the amount of tax that the debtor believes is due, the debtor may file an objection to the claim. In *In re Richard J. Morrell,*[53] the IRS filed tax claims and the creditors' committee objected to the tax claims and filed notice with the District Director in San Francisco. At the hearing, because the U.S. government was not represented, the objections of the creditors' committee were sustained and the claims were disallowed.

(v) Proper Notice

Bankruptcy Rules 9014 and 7004(b) provide that the U.S. Attorney for the district in which the action is brought and the U.S. Attorney General must be notified. On appeal, the District Court ruled that, because the creditors' committee failed to properly notify the U.S. Attorneys, the tax claims must be considered on their merits. The bankruptcy court's disallowance of the claims was reversed.

In a similar case,[54] the trustee notified the IRS (and the agent who had filed an amended proof of claim) of the trustee's objection to the amendment. The bankruptcy court held a hearing, and after the IRS failed to argue on the merits of the trustee's objections, the court disallowed the amended claim. On appeal, the District Court reversed the bankruptcy court's order striking the government's amended claim, on the ground that there was no justifiable excuse for improper service on the U.S. Attorney General.

In *In re Allan Ray Johnson,*[55] the taxpayer failed to provide notice to the IRS and the Colorado Department of Revenue to allow both agencies timely filing of their respective claims and objection to, or participation in, the bankruptcy proceedings and confirmation of the plan. The court drew its conclusion from the deficiencies described in the case, such as the debtor's failure to mail the amended plan, motion to confirm the (amended) plan, and notice of hearing to the Colorado Department of Revenue or to the IRS at a specific and appropriate

[53] 69 B.R. 147 (N.D. Cal. 1986).

[54] *In re F.C.M. Corp.*, 1987 U.S. Dist. LEXIS 15275 (S.D. Fla. 1987).

[55] 95 B.R. 197 (Bankr. D. Col. 1989). See *In re Herd*, 840 F.2d 757, 759 (10th Cir. 1988) and *Reliable Elec. Co., Inc. v. Olson Constr. Co.*, 726 F.2d 620, 623 (10th Cir. 1984).

IRS office address (preferably to the attention of a designated department, or an authorized person's attention) or in accordance with local court requirements. Debtor's documents were addressed to: "Internal Revenue Service—Ogden, Utah 84201." The court noted that, although this address might well be satisfactory for routine matters—such as filing a tax return or payment, conducting business in the ordinary course, or corresponding under normal circumstances—it is simply not sufficient in a pending bankruptcy case, particularly where taxes are at issue and in dispute. As a result of the defective notices, the court held that the IRS and the Colorado Department of Revenue were entitled to consideration of their late filed claims.

Bankruptcy Rule 2002 provides that, in a chapter 11 case, all notices should be mailed to the District Director of Internal Revenue for the district in which the case is pending.

There are conflicting rulings as to whether the IRS is precluded from filing a claim for employment taxes if not included in a list of creditors.

In *In re Cardinal Mine Supply, Inc.*,[56] the IRS filed a claim for employment taxes in 1985. A notice to creditors fixed December 19, 1983, as the date of the creditors' meeting in this chapter 7 case and stated that all claims had to be filed within 90 days of this date. The IRS was not listed as a creditor and had no knowledge of the bankruptcy until 1985. The trustee objected to the IRS's claim.

U.S. Bankruptcy Judge Lee ruled that the fact that the IRS did not receive notice of the claim in time to permit timely filing did not affect the result dictated by the applicable provisions of the Bankruptcy Code.

However, in *In re Ronald Elsworth Reichard*,[57] the bankruptcy court overturned a bankruptcy trustee's disallowance of a claim for $4,980 filed by the IRS. In this case, the court allowed the claim, even though the IRS had not filed a timely claim for the taxes, because the IRS had not received notice of the bankruptcy filing.

The Ninth Circuit BAP held, in *In re Williams*,[58] that an order reducing a claim of the IRS resulting from an objection by the taxpayer may be amended or altered if the notice to the IRS was improper. The BAP held that the taxpayers provided the wrong notice of objection and that they failed to properly serve the notice and motion as required by the federal government. The BAP noted that the proper notice was 30 days pursuant to Bankruptcy Rule 3007, and not the 10-day notice given by the Williamses under the local court rules.

The bankruptcy court held, in *In re Larry Merritt Co.*,[59] that the local rules may not be important in determining whether proper notice was given. The bankruptcy court held that the IRS received adequate notice of the chapter 7 filing. Even though local rules require that the notice be sent to the U.S. Attorney, the court ruled that notice to the U.S. Attorney was not required.

In a chapter 13 case, the bankruptcy court held that an IRS proof of claim that was not filed until after the claims bar date was disallowed, but that the

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[56] 1988 Bankr. LEXIS 2594 (Bankr. E.D. Ky. 1988).

[57] No. B-3-86-02362; LEXIS, 88 TNT 203-26 (Bankr. S.D. Ohio 1988).

[58] BAP No. EC-93-1121-AsRJ (Bankr. 9th Cir. Aug. 31, 1993).

[59] 166 B.R. 875 (Bankr. D. Tenn. 1993).

prepetition tax liability would not be discharged[60] The taxpayers did not list the IRS as a creditor, and their initial and first and second amended plans did not list the IRS as having a priority tax claim. The IRS was not notified of the bankruptcy until after the bar date when Schedule E was amended by the taxpayer to include the IRS as a creditor. The IRS filed a proof of claim shortly after the amended Schedule E was filed. The bankruptcy court held that the proof of claim was disallowed because it was filed after the bar date. Holding that the claim was not discharged, the court reasoned that the IRS should not be denied due process by disallowance of its untimely, unsecured claim. The tax claim was not provided for in the chapter 13 plan and consequently remains fully collectible after the case is concluded.[61]

The Fifth Circuit held that the confirmation of a plan does not substitute for a section 505 motion any more than it substitutes for an objection to a proof of claim.[62] The circuit court noted that the debtor failed to invoke the bankruptcy court's power to determine a tax debt, and the listing of the tax in his schedules, disclosure statement, and plan did not invoke that power.

The lesson from these cases is that proper notices must be served before the courts may adjust claims of taxing units.

The Tenth Circuit held, in *Donald W. Fairchild v. Commissioner*,[63] that the taxpayer could not unilaterally withdraw his objection to a proof of claim and thereby dismiss the contested matter. The taxpayer attempted to withdraw his objection the day before the bankruptcy court was to hold a hearing on the innocent spouse issue.

In *In re Bisch,*[64] the Ninth Circuit BAP held that there is no requirement in the Internal Revenue Code or the Bankruptcy Code that the IRS file a proof of claim for a secured tax lien. The court also concluded that the IRS did not waive its secured status by failing to file a proof of claim. The BAP pointed out that failure to file a proof of claim may mean that a creditor does not receive a distribution from the debtor's estate; however, the property is still liable for satisfaction of the debt. Citing *In re Junes,*[65] the court explained that, where a debtor fails to provide for an IRS lien in a chapter 13 case, the tax lien survives the bankruptcy process unaffected.

(vi) Priority Taxes

In *In re Pacific Atlantic Trading Co.,*[66] the Ninth Circuit held that the Service's priority claim, for which a proof of claim was filed over one year late, was allowed

[60] *In re Herndon*, 188 B.R. 562 (Bankr. E.D. Ky. 1995).
[61] *In re Gray*, 174 B.R. 228 (Bankr. E.D. Ky. 1994).
[62] *In re Taylor*, 140 F.3d 1040 (5th Cir. 1998).
[63] 969 F.2d 866 (10th Cir. 1992).
[64] 159 B.R. 546 (Bankr. 9th Cir. 1993).
[65] 99 B.R. 978 (Bankr. 9th Cir. 1989).
[66] 33 F.3d 1064 (9th Cir. 1994). In an unpublished memorandum the Ninth Circuit also held that sections 501 and 502 of the Bankruptcy Code authorize federal tax claims priority status regardless of when a proof of claim is filed and that section 726(a)(1) of the Bankruptcy Code provides that priority claims are entitled to first distribution regardless of when a proof of claim is filed. *In re Mantz*, 1994 U.S. App. LEXIS 22735 (9th Cir. 1994).

under the Bankruptcy Code and thus the IRS retained its right to first distribution, regardless of when it filed the proof of claim. The Circuit Court noted that 11 U.S.C. section 726(a)(l) does not distinguish between timely and late priority claims and, therefore, the Service's failure to comply with the time limits established in Bankruptcy Rule 3002(c) did not affect the tax claim's entitlement to first-priority distribution. The Ninth Circuit noted that Rule 3002(c) simply divides claims into two categories: (1) timely and (2) late, but does not disallow a late claim. In April 1994, the Second Circuit, in *In re Vecchio,*[67] also ruled that the bar date for claims provided in Bankruptcy Rule 3002 is void as to priority claims in a chapter 7 case, because 11 U.S.C. section 726(a)(1) does not distinguish between timely and untimely filed priority claims.

In *In re Chavis*,[68] the IRS received notice when John and Betty Chavis filed their chapter 13 petition in May 1991. The IRS filed a proof of claim for 1989 and 1990, and the bankruptcy court confirmed the couple's chapter 13 plan three days later, setting September 24, 1991, as the last day for creditors to file timely proofs of claim. Prior to this date, the IRS filed an "amendment" to its original proof of claim for a priority unsecured tax claim that included the previously filed amounts for 1989 and 1990, as well as listing liabilities for 1988 and 1991, for which the IRS sought priority unsecured status. The bankruptcy court disallowed the IRS's 1988 tax liability claim, concluding that Bankruptcy Rule 3002(c) establishes a bar date for filing certain proofs of claim in chapter 13 cases. The bankruptcy court concluded that the IRS's amended claim was filed after the bar date, and was thus untimely filed because it was not an amendment to the proof of claim filed earlier, but rather a new claim. The district court affirmed on appeal.

The Sixth Circuit affirmed, holding that the lower courts properly disallowed the IRS's late filed claim. The Sixth Circuit reached this decision in conflict with the decisions of the Second Circuit in *In re Vecchio,* and the Ninth Circuit in *In re Pacific Atlantic Trading Co.* Both of these courts allowed tardy claims in chapter 7 cases. The Sixth Circuit noted that these cases were decided on the rationale that conflicts between the Bankruptcy Code and the Bankruptcy Rules must be decided in favor of the Code. The Bankruptcy Code does not disallow tardy claims. The Sixth Circuit concluded that the Bankruptcy Code and Rules could be harmonized, noting that compliance with the timeliness requirement of Bankruptcy Rule 3002 is a prerequisite to the allowance of a proper claim under Bankruptcy Code section 502.

In disallowing the late filing of the proof of claim, the Sixth Circuit pointed to fundamental differences between chapter 7 and chapter 13 bankruptcies that limit the decisions in *Vecchio* and *Pacific Atlantic Trading* to chapter 7 type cases. The Sixth Circuit noted that chapter 13 serves as a flexible vehicle for the repayment of allowed claims, and that all unsecured creditors seeking payment under a chapter 13 plan must file their claims on a timely basis so that the efficacy of the plan may be determined in light of the debtor's assets, debts, and foreseeable earnings.

The Eleventh Circuit held that an untimely IRS claim for taxes under section 507(a)(8) of the Bankruptcy Code in a chapter 7 case should be paid as a priority

[67] 20 F.3d 555 (2d Cir. 1994).
[68] 47 F.3d 818 (6th Cir. 1995).

claim under section 726(a)(1) of the Bankruptcy Code.[69] The petition was filed prior to the effective date of the 1994 amendments to the Bankruptcy Code. The court followed the reasoning of *In re Pacific Atlantic Trading Co.* and *In re Vecchio,* and distinguished cases decided under chapter 13.

The Fifth Circuit held that a late-filed IRS proof of claim was allowed in a couple's chapter 13 case but was not entitled to first-tier status with the timely filed proof of claim.[70] The district court had previously held that the claim was disallowed. The Fifth Circuit affirmed the district court's refusal to allow the Service's late, amended proof of claim to relate back to the filing of the initial proof of claim.

The Fifth Circuit noted that Bankruptcy Rule 3002(a), establishing the bar date, must be viewed as providing a dividing line between timely and tardy claims, rather than a flat ban on the allowance of late-filed claims. The Fifth Circuit disagreed with the Second Circuit in *In re Vecchio,* where the Second Circuit viewed "the categorization of late-filed priority claims among other tardily filed allowed unsecured claims as leading to an absurd result."

A divided Ninth Circuit held that in a chapter 13 proceeding, a proof of claim filed by the IRS after the bar date set under Bankruptcy Rule 3002(c) was properly disallowed.[71] The petition was filed prior to the effective date of the Bankruptcy Reform Act of 1994.

The taxpayers filed a joint chapter 13 petition in July 1991, scheduling as priority unsecured debts approximately $25,000 in income and payroll taxes. Their plan, confirmed in October 1991, provided for full payment of these priority claims. The bankruptcy court set December 31, 1991, as a bar date for filing timely proofs of claim. The IRS timely filed a proof of claim in December 1991 for $11,746 for personal income tax. An amended return was filed in April 1992 listing income taxes of $31,000, and in November a second amended claim was filed that for the first time asserted a claim for unpaid payroll taxes. The bankruptcy court allowed the income tax portion of the November 1992 amended claim but disallowed the amendment relating to payroll taxes. The court disallowed the payroll tax claim because it was of a character different from those set forth in the original proof of claim and thus was untimely filed pursuant to Rule 3002(c). The Ninth Circuit Bankruptcy Appellate Panel affirmed.

The Ninth Circuit ruled that the timeliness issue was controlled not by amended section 502(b)(9) of the Bankruptcy Code, as added by the Bankruptcy Reform Act of 1994, but by the rules and authorities governing cases filed before October 23, 1994, specifically, Bankruptcy Rule 3002(c).

The court noted that timeliness is of the essence in claims filed in chapter 13 reorganization and that this case was governed by the strict time requirements on filing claims set forth in *In re Tomlan*,[72] where the Ninth Circuit had held that the law is clear—the bankruptcy court has no discretion to allow a late-filed proof of claim in a chapter 13 case. In reference to *In re Pacific Atlantic Trading*

[69] *In re Davis*, 81 F.3d 134 (11th Cir. 1996).
[70] *In re Waindel*, 65 F.3d 1307 (5th Cir. 1995).
[71] *In re Osborne*, 76 F.3d 306 (9th Cir. 1996).
[72] 907 F.2d 114 (9th Cir. 1990).

Co., which might suggest a different rule, the Ninth Circuit concluded that Pacific Atlantic applied only in chapter 7 proceedings.

In describing the difference in the impact between a chapter 7 and 11 case, the Ninth Circuit noted that it is not a matter of allowance or disallowance of claims, because a claim disallowed as a result of late filing can be specially allowed in chapter 7 proceedings prior to distribution of the estate property to the debtor. However, in a chapter 13 case, the court concluded that a chapter 13 debtor retains the assets of the estate in exchange for an agreement to make periodic payments to the creditors that must equal or exceed the amount that the creditors would receive under chapter 7. The debtor thus has an interest only in whatever is ultimately left over, after all claims have been paid. The Ninth Circuit then noted that if late-filed claims are not barred in chapter 13 actions, it would not be possible to determine with finality whether a chapter 13 plan satisfies this standard.

There still remains considerable uncertainty as to the tax impact resulting from a tardy-filed proof of claim, including those in a chapter 11 case. For petitions filed after October 22, 1994, the Bankruptcy Reform Act of 1994 may have helped clarify the issue, dealing with the conflict between the rules and the Bankruptcy Code. Section 502(b) of the Bankruptcy Code was amended to provide that a claim of a governmental unit, including tax claims, will be considered timely if filed before 180 days after the order for relief or such later time as the Federal Rules of Bankruptcy may provide. Section 502 was also amended to provide that a proof of claim not timely filed will not be allowed, except for the governmental claim mentioned above and tardy claims permitted under section 726 of the Bankruptcy Code. The change did not deal with the issue of how to distinguish a tardy proof of claim from an amended proof of claim. The Bankruptcy Reform Act did not address the issue as to the extent to which section 726 of the Bankruptcy Code applies to chapter 11 cases.

However, in *In re Larry Merritt Co.*,[73] the bankruptcy court held that the claim for unpaid prepetition payroll taxes was not entitled to priority because the IRS had received adequate notice and failed to file a timely proof of claim. The IRS filed its proof of claim five months after the bar date. The district court affirmed, citing *In re Century Boat Co.*,[74] where the Sixth Circuit upheld the statutory policy of orderly distribution and settlement of estates as provided for in section 726(a) of the Bankruptcy Code. The district court held that a priority creditor's untimely claim should be subordinated under 11 U.S.C. section 726(a)(3) if the creditor had notice of the claims bar date and failed to comply with the timing requirements.[75]

(vii) Burden of Proof

The general bankruptcy rule is that the burden of proof for a claim against a debtor lies with the creditor. Although it may be the responsibility of the

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[73] 166 B.R. 875 (Bankr. E.D. Tenn. 1993).
[74] 986 F.2d 154 (6th Cir. 1993).
[75] *In re Larry Merritt Co.*, 169 B.R. 141 (E.D. Tenn. 1994).

debtor to object to a claim and place the issue before the bankruptcy court, the burden of persuasion is on the creditor seeking to enforce the claim.[76] The general tax rule is that the burden of proof is upon the taxpayer. Tax Court Rule 142(a) provides that "[t]he burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon respondent." An example of a statutory exception is for fraud, where I.R.C. section 7454 transfers the burden of proof to the IRS by providing that the Service must prove fraud by clear and convincing evidence.

California's Franchise Tax Board filed a claim in Stephen MacFarlane's bankruptcy case, based on the disallowance of bad debt deductions.[77] MacFarlane objected and submitted evidence on the existence and worthlessness of the claimed debts. The bankruptcy court found MacFarlane's evidence sufficient to shift to the state the burden of proving the factual basis for the tax claim. The Franchise Tax Board elected not to conduct discovery or to submit additional evidence, and the bankruptcy court sustained MacFarlane's objection. The district court agreed with the bankruptcy court's assignment of the burden of proof but, on the merits, reversed the judgment for MacFarlane.

The Ninth Circuit held that taxing authorities, like other bankruptcy claimants, bear the ultimate burden of proving their claims. The Ninth Circuit noted that under California law, outside the bankruptcy context, a taxpayer bears the ultimate burden of demonstrating his entitlement to a deduction. Adopting the reasoning of the Fifth, Eighth, and Tenth Circuits, the Ninth Circuit held that because tax claims already receive a statutory priority over other creditors' claims, relieving the Franchise Tax Board of its burden of proof would be granting to the Franchise Tax Board a double benefit not authorized by statute. Quoting *In re Wilhelm*,[78] the Ninth Circuit noted that policy goals of the bankruptcy system are put at risk when one class of creditors is given the benefit of a favorable presumption that has its origins outside bankruptcy law.

The Fifth and Tenth Circuits have also agreed with the Ninth Circuit.[79] In contrast, the Third, Fourth, and Seventh Circuits[80] have applied the general tax rule that places the burden of proof on the taxpayer rather than the tax authority, including the IRS.

The Supreme Court[81] affirmed a Seventh Circuit case holding that the burden of proof on the tax claim in bankruptcy remained on the petitioner, the trustee of the debtor's estate. The Supreme Court held that the bankruptcy did not alter the burden imposed by the substantive law and that the bankruptcy

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[76] *See In re Allegheny Int'l, Inc.*, 954 F.2d 167 (3d Cir. 1992); *In re Fullmer*, 962 F.2d 1463 (10th Cir. 1992).

[77] *In re MacFarlane*, 83 F.3d 1041 (9th Cir. 1996), *cert. denied*, 117 S. Ct. 1243 (1977).

[78] 173 B.R. 398 (Bankr. E.D. Wis. 1994).

[79] *In re Placid Oil Co.*, 988 F.2d 554 (5th Cir. 1993); *In re Fullmer*, 962 F.2d 1463 (10th Cir. 1992).

[80] *Resyn Corp. v. United States*, 851 F.2d 660 (3d Cir. 1988); *In re Landbank Equity Corp.*, 973 F.2d 265 (4th Cir. 1992); *United States IRS v. Charlton*, 2 F.3d 237 (7th Cir. 1993).

[81] *Raleigh, Chapter 7 Trustee v. Illinois Department of Revenue*, 530 U.S. 120 (2000).

estate's obligation to respondent was established by the state's tax code. The Court noted that the Bankruptcy Code had no provision for altering the burden on a tax claim, and its silence said no change was intended.

Generally, the Eighth Circuit assignment of the burden of proof has varied. However, as noted later, the Eighth Circuit has tended to agree with the courts holding that the general tax rule applies.

The Eighth Circuit affirmed the dismissal of a couple's chapter 12 bankruptcy on the ground that the debtors failed to carry their burden of showing that the IRS's proof of claim was erroneous. The taxpayers filed a chapter 12 petition, and the IRS filed a proof of claim for over $600,000 in taxes, penalties, and interest based on findings that income nominally received by corporations should be attributed to the taxpayers. The taxpayers objected, stating that their returns, filed in response to a bankruptcy court order, showed that they did not owe any federal tax. The taxpayers did not appear in person and relied on the testimony of their return preparer and on presumptions in favor of corporate separateness and the validity of their tax returns. Both the bankruptcy court and the district court held that the taxpayers had failed to rebut the prima facie validity of the IRS proof of claim, and dismissed the case. The Eighth Circuit affirmed by holding that the taxpayers' evidence was insufficient to shift the burden of proof to the IRS.[82]

The Ninth Circuit held that the state of California is not required to file documentation in support of its proof of claim for use taxes.[83] The Ninth Circuit concluded that Bankruptcy Rule 3001(c), which requires that a claim be supported by documentation, applies to claims based on a writing and not on a statute. The Ninth Circuit noted that in the case of a use tax, the obligation to pay the tax is created solely by the completion of a transaction to which the state statute applies.

(c) Tax Refund

Section 505(a)(2) of the Bankruptcy Code provides that, before the bankruptcy court can determine the right of the estate to a tax refund, the trustee must file a claim for the refund and either receive a determination from the IRS or allow 120 days to pass after the claim is filed. If the 120-day period expires and the IRS has not made a determination, the bankruptcy court can then determine the right of the estate to a tax refund. Under prior law, the bankruptcy court did not have the right to hear suits for tax refunds. It was necessary for the trustee or debtor to file suit in a District Court or the Court of Claims.

The bankruptcy court held that a debtor is not entitled to a refund of taxes paid more than three years before he filed his bankruptcy petition, because he

[82] *In re Brown*, 82 F.3d 801 (8th Cir. 1996). *See In re Gran*, 964 F.2d 822 (8th Cir. 1992); *In re Uneco*, Inc., 532 F.2d 1204 (8th Cir. 1976).

[83] *California State Bd. of Equalization v. Los Angeles Int'l Airport Hotel Assocs.*, 106 F.3d 1479 (9th Cir. 1997).

filed his refund claim more than three years after he paid the taxes. The refund claim was barred by the statute of limitations in I.R.C. Section 6511.[84]

The Eighth Circuit BAP held that a bankruptcy court lacked subject matter jurisdiction to determine a debtor's entitlement to a tax refund for postpetition years, because the debtor failed to first file refund claims.[85] The IRS filed a proof of claim for $143,000 in taxes from the debtor's failure to report $500,000 of embezzlement income for taxable year 1989 in the taxpayer's chapter 11 case. Approximately two years later, the taxpayer filed a motion to reconsider because restitution of the embezzled funds was partly made in 1990-1994 and he was entitled to a tax refund in those years. The bankruptcy court determined that the taxpayer was entitled to the refunds and permitted an offset against the IRS's proof of claim.

The IRS appealed on the basis that the bankruptcy court lacked subject matter jurisdiction over the 1990-1994 tax years because the taxpayer had not filed refund claims with the IRS for those years as required by I.R.C. section 7422. Vacating the lower court's decision, the Eighth Circuit BAP held that the refund procedures contained in the I.R.C. and the tax regulations must be pursued as a condition to bankruptcy court jurisdiction over refund disputes. On appeal, the Eighth Circuit reversed the decision of the BAP and held that under section 505(a) the bankruptcy court had jurisdiction to determine the tax liability beyond the years stated in the proof of claim when the liability involved deductions resulting from repayment of embezzled funds.[86]

The bankruptcy court held that a bankruptcy trustee can recover a debtor's tax refund under the authority of section 542 of the Bankruptcy Code, even though the trustee had not timely filed a refund claim under section 6511.[87] The court ruled that it was not equitably tolling the I.R.C. limitations period in violation of *United States v. Brockamp.*[88]

The court acknowledged that a bankruptcy trustee must generally file a refund claim but said that that rule does not apply here due to the specific facts of this case. When the government, the debtor, and the trustee agree on the amount of an overpayment, the court concluded that the claim has been liquidated and the debtor's interest in the liquidated amount becomes property of the bankruptcy estate. The trustee has no need to commence the refund process under the I.R.C. because the Bankruptcy Code compels the turnover under 11 U.S.C. section 542. Under these facts, the I.R.C. claims process is superseded by bankruptcy law, and thus section 6511 does not apply.

[84] *In re Farrell*, 211 B.R. 79, 97-1 U.S. Tax Cas. (CCH) ¶ 50,395; 79 A.F.T.R.2d (P-H) 2037 (Bankr. M.D. Fla. 1997).
[85] *In re Kearns*, 219 B.R. 823 (8th Cir. B.A.P. 1998).
[86] *U.S. v. Kearns*, 177 F.3d 706 (8th Cir. 1999).
[87] *In re Armstrong*, 217 B.R. 192 (Bankr. N.D. Tex. 1997).
[88] 117 S. Ct. 849 (1997).

The bankruptcy court[89] held that the debtor may not dismiss a case to receive a tax refund. The taxpayer filed a bankruptcy petition and subsequently moved to have it dismissed when he learned that he was entitled to receive a tax refund. The court noted that although individuals have an absolute right to file a bankruptcy petition, they have no absolute right to dismiss it. Generally, most courts allow an individual to move to dismiss his or her case only when cause exists. The court examined whether dismissal would cause the creditors prejudice and found that, although the taxpayer promised to use the tax refunds to pay his creditors, he had no plan to honor his commitment, noting that Stephenson could spend the refunds and then refile his bankruptcy petition, thus avoiding his creditors. The bankruptcy court refused to dismiss the filing because the taxpayer failed to meet his burden of showing that his creditors would not be prejudiced by the dismissal of his petition.

(d) Determination of Unpaid Tax Liability

The Bankruptcy Code contains a very important provision that requires a governmental unit to determine the tax liability or be prohibited from making assessments of any amount other than that shown on the return. Section 505(b) of the Bankruptcy Code provides that a debtor, or trustee if appointed, may request a determination of any unpaid liability of an estate for any tax incurred during the administration of the case. The request is made by submitting a return for such a tax and a request for determination to the governmental unit charged with responsibility for collection or determination of the tax. Unless such return is fraudulent or contains a material misrepresentation, the trustee, the debtor, and any successor to the debtor are discharged from any liability other than the amount shown on the return. Before the bankruptcy court can determine the tax, a request must be made for the taxing unit to determine the tax.

The taxpayer is not required to use all administrative remedies before the bankruptcy court can determine the amount of the tax. In *In re Piper Aircraft Corp.*,[90] the bankruptcy court held that the bankruptcy court could determine the amount of the debtor's tax, even though the debtor did not comply with state administrative procedures. Other bankruptcy courts have also given the bankruptcy court authority to determine the tax without pursuing all available remedies first.[91] However, one bankruptcy court subsequently limited the Ledgemere decision to unpaid taxes owed by the debtor and would not extend it to refund claims that had not been previously adjudicated.[92]

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[89] *In re Todd A. Stephenson*, 262 B.R. 871 (Bankr. W.D. Okla. 2001).

[90] 171 B.R. 415 (Bankr. S.D. Fla. 1994)., *aff'd* 168 B.R. 434 (S.D. Fla.1994).

[91] *In re AWB Assocs.*, 144 B.R. 270 (Bankr. E.D. Pa. 1992); *In re 499 W. Warren Street Assocs. Ltd.*, 143 B.R. 326 (Bankr. N.D.N.Y. 1992); *In re Ledgemere Land Corp.* 135 B.R. 193 (Bankr. D. Mass. 1991).

[92] *In re Cumberland Farms, Inc.*, 175 B.R. 138 (Bankr. D. Mass. 1994), *aff'd* 78 F.3d 10 (1st Cir. 1996).

If the return filed has been selected for examination, the taxing unit must notify the debtor of the examination within 60 days after the request for tax determination is made. The taxing unit has 180 days after the request is made to complete the examination. For cause, additional time may be granted by the bankruptcy court. An extension would be expected to be granted for a reasonable time period to allow the taxing unit to complete the audit.

If the taxing unit does not notify the taxpayer within 60 days of the request that an examination will be conducted or if the taxing authority does not complete the examination within the prescribed time, the taxing unit will be prohibited from taking any action to file a claim for any amount other than the amount specified on the return. In *In re T. Horace Estes,*[93] the IRS determined that the trustee had miscalculated the tax due on returns for fiscal years 1984 through 1986 that were filed in October 1986, but did not timely notify the trustee. The court ruled that neither the trustee nor the debtors are personally liable for any taxes, penalties, or interest attributable to the errors made by the trustee, because he had complied with all of the requirements of section 505(b) of the Bankruptcy Code.

In *In the matter of Harry Fondiller,*[94] the district court held in a chapter 7 case that if a claim is timely filed, even though it is not filed within the 60 days after the request was made for the determination of the tax, the claim will be allowed against the estate. The court made a clear distinction between a claim against an estate and a claim against the individual. The court ruled that the estate and the successor to the debtor are two separate entities and are not the same. The court reached this conclusion because section 505(c) of the Bankruptcy Code specifically uses the term estate as distinct from a successor to the debtor. Thus, although the IRS may not have a basis to assess the tax against the individual, it can collect the tax from the estate.

In situations where there are no assets in the estate and records are in such a condition that it would involve substantial cost to determine the information to file a tax return, the trustee for the debtor may request that the IRS remove the debtor from the tax rolls. The request may take the form shown in Exhibit 10.1.

Rev. Proc. 81-17[95] provides that if a trustee wishes to request a prompt determination of any unpaid tax liability of an estate, a written application, in duplicate, with both copies signed under penalties of perjury, requesting a prompt determination must be filed with the District Director for the district in which the bankruptcy case is pending. The application is to be marked: "Personal Attention of the Special Procedures Function. Do Not Open in Mailroom." Two exact copies of the return filed by the trustee with the IRS for a completed taxable period, and a statement of the name and location of the district office where the return was filed, must be submitted with the application.

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[93] No. 383-01063; LEXIS, 87 TNT 230-12 (Bankr. M.D. Tenn. 1987), *aff'd* 87 B.R. 52 (M.D. Tenn. 1988).

[94] 125 B.R. 805 (N.D. Cal. 1991).

[95] 1981-1 C.B. 688.

EXHIBIT 10.1

Notice of Lack of Funds and Request for Removal from Tax Rolls Sample

Personal Attention of the [on exterior of delivery]

Special Procedures Function

Do not open in mailroom

District Director of Internal Revenue

Attention: Special Procedures

____

____

Chapter Bankruptcy Estate of XYZ Corporation
FEIN 36-xxxxxxx
Request for 60-day closing of statute of limitations
under § 505(b) of the U.S. Bankruptcy Code

I am the chapter trustee appointed by the United States Bankruptcy Court for the captioned corporate bankruptcy estate. The chapter case commenced on ______, 20_, and I was appointed by the Bankruptcy Court on ______, 20_. From and after the date of my appointment, I have generated $_ from the sale of assets and $_ as investment earnings. The fiscal year-end of the corporation, prior to the commencement of the case, was .

There currently is a severe inadequacy of cash in the estate for payment of postpetition administrative claims. None of these claims is for payroll taxes, insofar as I have made no payments for postpetition payroll, and all employees were dismissed on or prior to the commencement of the chapter case. Prior to the commencement of the case, all available information indicates that the prepetition debtor operated at a severe loss, including for the portion of its tax year during which it operated prior to the commencement of the case. The amount of proceeds I have realized from liquidation of assets and investment income is, in the aggregate, less than $40,000. Accordingly, it appears to be impossible for the estate to incur any federal income tax liability, even for corporate alternative minimum taxes. A federal income tax return indicating "NONE" as taxes due on account of year ended ______, 20_ is enclosed in duplicate, along with requests in duplicate for 60-day procedure under § 505(b) of the United States Bankruptcy Code. Attached to the return are the schedules filed with the Bankruptcy Court in the case.

I respectfully request that you accept the enclosed return as adequate under the circumstances described, and that you remove the debtor and the estate from the tax rolls as relating to tax return filing for periods after that covered by the enclosed return.

Very truly yours,
[Signature]
Trustee

cc w/enc.: IRS Service Center

Source: Adapted from Kenneth J. Malek, "Basic Taxation," *Proceedings*, 7th Annual Reorganization and Bankruptcy Conference, Association of Insolvency Accountants (Westlake Village, CA; Association of Insolvency Accountants, 1991), pp. 30-31.

A discharge of any additional liability will be granted on payment of the tax stipulated in the return if:

- The taxing unit accepts the return as filed by not notifying the debtor that the return will be examined;
- The taxing unit conducts an examination and determines that additional taxes are due, and the debtor accepts the taxing unit's examination results and pays the additional tax;
- The taxing unit conducts an examination and determines that additional taxes are due; the bankruptcy court determines, after proper notice and hearing, that the additional taxes are proper; and the debtor pays the additional taxes due;
- The taxing unit does not complete the examination and notify the debtor of an additional tax due within 180 days, including extensions granted by the bankruptcy court, after the request was filed.[96]

A discharge will not be granted if the tax return submitted is fraudulent or contains a material misrepresentation.[97]

After the taxpayer in *George Louis Carapella v. United States*[98] was discharged from bankruptcy, the government contended that the taxpayer remained liable for the taxes because fraudulent returns were filed and attempts were made to evade tax liability for 3 years. The court agreed with the IRS, which claimed that the tax liability falls within the exception to discharge under 11 U.S.C. section 523(a)(1). In *La Difference Restaurant, Inc.,*[99] the court held that the IRS was enjoined from seeking to collect taxes, penalties, and interest allegedly owed by the debtor on the ground of equitable estoppel. This deficiency, which the IRS was unable to collect, related to the difference between the original proof of claim and the amount based on an agreement the debtor had made with the IRS and had then used in developing a plan that was subsequently confirmed. This ruling was made by the court even though a clause in the plan provided that, if additional taxes have not been claimed prior to confirmation and are determined to be due, they will be paid immediately.

If a taxpayer petitions the court to determine a tax liability under section 505 of the Bankruptcy Code, it is important that the IRS be properly served. Rule 7004(b)(4) of the Federal Rules of Bankruptcy Procedure provides that, in the case of an adversary proceeding, a copy of the summons and complaint must be sent to the U.S. Attorney for the district in which the action is brought and to the U.S. Attorney General at Washington, DC. In any action attacking the validity of an order of an officer or agency of the United States not made a party, a copy of the summons and complaint must also be mailed to the officer or agency. In the case of tax claims, the notice should be mailed to the Special Procedures Staff in the district where action is brought.

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[96] *Id.* § 505(b).
[97] *Id.*
[98] 105 B.R. 86 (Bankr. M.D. Fla. 1989), *aff'd* 115 B.R. 365 (Bankr. M.D. Fla. 1990).
[99] 86-2 USTC (CCH) ¶ 9568 (D.C.N.Y. 1986).

In *In re Johnny Ray Warren,*[100] the bankruptcy court ordered the taxpayer's case reopened because the court had lacked personal jurisdiction over the government at the time it had entered a previous order. Warren filed for bankruptcy and petitioned the court to have his tax liability determined. Notice was served on the IRS Special Procedures Staff and on the U.S. Attorney in Dallas. Notice was not served on the Attorney General of the United States as required by Bankruptcy Rule 7004(b)(4). The bankruptcy court entered default judgment and held Warren not liable for the penalty under I.R.C. section 6672.

In *In re Smith,*[101] a Ninth Circuit BAP held that section 505 of the Bankruptcy Code does not authorize a proceeding seeking an order of turnover and an order enjoining the lottery commission from complying with the withholding requirements of I.R.C. section 3402. The court noted that the trustee did not ask the bankruptcy court to determine the amount or legality of any tax, fine, penalty, or addition to tax. Richard Smith, who won the Washington State Lottery entitling him to an annual payment of $50,000, filed a chapter 7 petition. The trustee filed a motion under section 505(a) of the Bankruptcy Code to determine whether the lottery commission could pay all winnings to the estate without withholding funds as required under I.R.C. section 3402. The bankruptcy court approved an order that provided for the full amount to be remitted to the estate and for the trustee to pay all taxes due. The BAP reversed. The BAP also rejected the trustee's argument that section 7421 of the Anti-Injunction Act did not apply, citing *In re American Bicycle Association,*[102] and *United States v. American Friends Service Commission.*[103]

In *In re Queen,*[104] Bobby Queen filed a chapter 7 petition and received a discharge of all dischargeable debts. The IRS subsequently levied on Queen's wages, attempting to collect an I.R.C. section 6672 penalty assessment. Queen requested the bankruptcy court to reopen the case. The bankruptcy court held that the penalty was excepted from discharge, declined to rule on the issue of Queen's liability for the penalty assessment, and dismissed without prejudice.

Queen appealed, and the district court and the Fourth Circuit ruled that the section 6672 penalty was not dischargeable. The Fourth Circuit rejected Queen's argument that the bankruptcy court had failed to recognize it had discretion under section 505 of the Bankruptcy Code to rule on the merits of the issue of his liability for the section 6672 penalty and that this constituted an error of law subject to de novo review by the district court. The Fourth Circuit pointed out that the bankruptcy court had noted that it could have decided the issue, but the bankruptcy court concluded that a refund case in district court would be more appropriate because the bankruptcy case was a no-asset case. The Fourth Circuit concluded that the bankruptcy court did not abuse its discretion.

[100] No. 390-37282-RCM-7 (Bankr. N.D. Texas 1991).
[101] 158 B.R. 813 (Bankr. 9th Cir. 1993).
[102] 895 F.2d 1277 (9th Cir. 1990).
[103] 419 U.S. 7 (1974).
[104] 1994 U.S. App. LEXIS 933 (4th Cir. 1993).

In *In re Teal,*[105] the Fifth Circuit held that a debtor may not challenge the legality of a penalty on which the Tax Court has previously ruled.

James Teal filed, in 1983, an amended 1979 return claiming a $13,000 refund with respect to a tax shelter investment. The IRS made a refund, but two years later notified Teal that he was liable for that amount, plus penalties and interest. Teal petitioned the Tax Court, but Teal and the IRS settled the dispute. Teal agreed to pay back the $13,000 refund and part of the penalty and interest. The Tax Court entered the stipulated decision.

In 1990, Teal filed a chapter 7 petition and commenced an adversary proceeding to determine the dischargeability of the liability for the penalty and interest. The bankruptcy court dismissed the complaint for lack of jurisdiction. However, the district court reversed and held that relitigation of those issues was not precluded by either section 505(a)(2)(A) of the Bankruptcy Code or the doctrine of claim preclusion. The district court concluded that the penalty and interest were thus dischargeable.

The Fifth Circuit reversed the district court's decision. The appeals court held that the bankruptcy court lacked jurisdiction, noting that the district court erred in finding that the Tax Court decision assessing the amount of taxes and penalties was not an adjudication of the legality of those items. The appeals court noted that a decision as to the amount of an assessment presupposes the legality of that assessment. The Fifth Circuit also ruled that the fact that the Tax Court decision was reached by agreement does not alter this conclusion, nor does it mean that the Tax Court decision was not a final judgment for purposes of res judicata.

In *Delpit v. Commissioner,*[106] the Ninth Circuit held that an appeal of a Tax Court decision is stayed by section 362 of the Bankruptcy Code. The Ninth Circuit noted that the first clause of section 362(a)(1) provides that a stay shall be imposed on the commencement or continuation of judicial or administrative proceedings against the debtor that were commenced before the commencement of the bankruptcy case, and the second clause provides that a stay shall be imposed on the commencement or continuation of judicial or administrative proceedings to recover a claim against the debtor that arose before commencement of the bankruptcy case. The court held that both clauses apply to an appeal pending from a Tax Court judgment concerning a tax deficiency of a debtor that is in bankruptcy.

The court reasoned that an appeal of a Tax Court decision is a continuation of an administrative proceeding against the debtor within the meaning of section 362(a)(1) of the Bankruptcy Code.

The Ninth Circuit rejected the government's contention that the taxpayer's reading of section 362(a)(1) of the Bankruptcy Code effectively renders section 362(a)(8) superfluous. The appeals court also rejected as "faulty" the reasoning of *Freeman v. Commissioner,*[107] which held that section 362(a)(1) does not apply to Tax Court appeals. The government's contention that section 505 of the

[105] 16 F.3d 619 (5th Cir. 1994).
[106] 18 F.3d 768 (9th Cir. 1994).
[107] 799 F.2d 1091 (5th Cir. 1986).

Bankruptcy Code requires the court of appeals to hear the Delpit case was rejected by the Ninth Circuit.

The bankruptcy court may not determine the tax of a partner that has not filed a bankruptcy petition. In *In re Mund Bros.*,[108] the trustee filed an amended partnership return and Schedule K-1, seeking to have the partnership declared as the entity that should pay the tax liability on the reported gain and income. The parties filed a stipulation providing that the inclusion of the brothers' assets and liabilities in the administration of the bankruptcy indicated a joint proceeding involving the partnership and the individuals.

The bankruptcy court ruled that it lacks jurisdiction over the individual partners. The court looked to the original bankruptcy petition and schedules, and determined that they all show the partnership as the debtor. The court noted that a bankrupt partnership is a separate entity from its partners, and that I.R.C. sections 1398 and 1399 provide that no separate taxable entity results when a partnership files for bankruptcy.

According to the Ninth Circuit in *American Principals Leasing Corp. v. United States*,[109] the district court correctly concluded that it lacked bankruptcy jurisdiction to determine the tax liability of the nondebtor partners for the activities of the debtor partnerships or to determine the consequences of the partnerships' activities. However, in *In re Schmidt*,[110] the bankruptcy court held that it has jurisdiction to determine the short-year, postpetition tax liabilities of a group of chapter 11 debtors who elected to split their taxable year under section 1398. The Schmidt court, in disagreeing with *American Principals Leasing Corp.*, held that the plain meaning of the term any tax in section 505(a) includes the partners' postpetition tax liabilities that are to be paid under the debtors' chapter 11 plans. The bankruptcy court reasoned that the tax determination will directly affect the partners' estates and the amount of other creditors' distributions, that the determination is necessary for the orderly and efficient administration of the confirmed plans, and that the partners have a personal stake in the outcome of their short-year tax liabilities.

The bankruptcy court would not determine the dischargeability of a tax claim in a no-asset case where the government conceded that the taxes were discharged.[111] However, with respect to a responsible person penalty, the court ruled that a determination on that issue would clearly and significantly assist the taxpayer's attempt to obtain a fresh start in life. On appeal the court noted that "Once an individual is established as a 'responsible person,' the burden shifts to the individual to disprove willfulness." Thus, because the bankruptcy court employed the wrong legal standard in allocating the burden of proof as to the critical element of willfulness, its findings were made under this erroneous view.[112] Another bankruptcy court held that the issue of liability under section 6672 is not complex and that it would be cost prohibitive for the debtor to liti-

[108] 1993 Bankr. LEXIS 2034 (Bankr. C.D. Ill 1993).
[109] 904 F.2d 477 (9th Cir. 1990).
[110] 205 B.R. 394 (Bankr. N.D. Ill. 1997).
[111] *In re Macagnone*, 216 B.R. 668 (Bankr. M.D. Fla. 1997).
[112] *In re Macagnone*, 240 B.R. 444 (M.D. Fla. 1999).

gate the issue elsewhere. The court rejected the IRS's contention that the discharge issue was tangential to the taxpayer's bankruptcy proceeding. The court noted that the taxpayer's liability for the penalty is critical to determining dischargeability.[113]

A bankruptcy court denied a man's motion to reopen his bankruptcy case to address the dischargeability of his tax liabilities, emphasizing that no bankruptcy purpose would be served by granting the motion. The court noted that while the liabilities in general were discharged, the tax liabilities may not have been discharged in the taxpayer's bankruptcy case and that another court could determine whether they were.[114]

The Pennsylvania Supreme Court affirmed a lower court opinion, concluding that five IRS tax liens were valid because the issue had already been decided by federal Courts.[115] Both the district court and the bankruptcy court previously determined that the liens filed against David Fuller were valid in a subsequent bankruptcy petition.

The Third Circuit[116] held that a bankruptcy court lacked jurisdiction to grant a corporation's request for a refund and offset of real property taxes where the corporation failed to follow state refund procedures.

The Third Circuit held that, based on section 505(a)(2)(B)'s legislative history, case law interpreting the provision, and public policy considerations, the bankruptcy court did not have jurisdiction to order the city to refund excess payments for those years in which Custom paid the taxes but did not contest them under the requirements established by New Jersey law. Because Custom did not and could not file appeals of the tax assessments within the time requirements established by New Jersey law, its claim for offsets based on overpayments was time-barred.

In a multistate receivership/bankruptcy entity, the Tenth Circuit[117] held that the Declaratory Judgment Act, 28 U.S.C. § 2201(a) prohibits the district court from determining corporate tax liabilities in a receivership action. The Tenth Circuit also held that the receiver could not rely on section 505 of the Bankruptcy Code to determine the tax in a receivership proceeding outside of bankruptcy court. The Tenth Circuit further held that the Anti-Injunction Act, I.R.C. section 7421(a), bars the district court from enjoining the Service from assessing and collecting taxes for failure to evaluate tax returns by a court-imposed deadline.

(e) Determination of Tax Aspects of a Plan

Section 1146 of the Bankruptcy Code gives the proponent of a chapter 11 plan the right to request a determination of the state and local tax aspects of the plan for debtors. A request for tax impact of a plan is not available for federal taxes.

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113 *In re Sideris*, 1997 Bankr. LEXIS 1995, 98-1 U.S. Tax Cas. (CCH) ¶ 50,104, 80 A.F.T.R.2d (RIA) 8326 (Bankr. N.D. Ga. 1997).

114 *In re Young*, 1997 Bankr. LEXIS 1893, 80 A.F.T.R.2d (RIA) 8250 (Bankr. N.D. Ill. 1997).

115 *Fuller v. Fair*, No. 00429 (Pa. Nov. 25, 1997).

116 *In re Custom Distribution Services Inc.*, 224 F. 3d 235 (3d Cir. 2000).

117 *Sterling Consulting Corp. v. United States*, 245 F.3d 1161 (10th Cir. 2001).

The determination, however, is limited to questions of law. If the party that requested the determination objects to the answer received, the bankruptcy court has the authority to resolve the issue.[118] Before a decision is made, the judge must receive a determination from the state and local taxing authorities or 270 days must pass after the request was made. Sheinfeld and Caldwell suggested that the following are areas for prospective litigation: What is a question of law? What are the taxing units to which a proper determination request can be made? When in fact does a controversy exist? May the 270-day limitation period be extended? What in fact is a response to the request for determination? May every proponent of each plan of reorganization independently request a determination from the taxing unit? Who is bound by the response of the taxing unit?[119]

The district court affirmed bankruptcy court decision to reopen a confirmed chapter 11 plan more than a year after confirmation to correct a computational error stipulated by the parties.[120] The taxpayer and the IRS entered into a stipulation fixing the tax liability and the bankruptcy court entered an order accepting the stipulated amount. The plan was confirmed and three weeks later, the IRS discovered a computation error caused by a misplaced decimal point, resulting in an understatement of taxpayer's liability for over $52,000. The IRS filed an amended proof of claim but did not seek to modify or revoke the chapter 11 plan until after all payments provided for in the plan were paid. The IRS then demanded an additional $69,000 in a reopened plan.

The district court held that the bankruptcy court had jurisdiction to reopen the plan, rejecting the taxpayer's position that under Fed. R. Civ. P. 60(b)(1) the plan could not be reopened after one year following confirmation, except in cases of mistake or inadvertence. The district court held that clerical errors may be corrected at any time, under Rule 60(a), subject to the court's discretion. The court reasoned that correcting a clerical error does not involve a change of intent by the parties or the court.

The Sixth Circuit has held that an unexpected tax refund received by a couple after confirmation of their chapter 13 plan was disposable income under section 1325(b)(1)(B) of the Bankruptcy Code that the debtors must turn over for distribution to creditors.

The Circuit Court held that the state exemption is irrelevant and that the disposable income issue under section 1325(b) turns on whether the refund income was necessary for the debtor's maintenance or support. The taxpayers, according to the Court, had agreed that all tax refunds would go to the plan to repay creditors and had made no argument that the income was needed for maintenance and support of themselves or their dependents.[121]

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[118] 1981-1 C.B. 688, § 1146(d).

[119] Sheinfeld and Caldwell, Taxes: An Analysis of the Tax Provisions of the Bankruptcy Code and the Bankruptcy Tax Act of 1980, 55 *Am. Bankr. L. J.* 97, 129, 130 (1981).

[120] *In re Dearing*, 1996 U.S. Dist. LEXIS 9126, 96-2 U.S. Tax Cas. (CCH) ¶ 50.422 (E.D. Wash. 1996).

[121] *In re Freeman*, 86 F.3d 478 (6th Cir. 1996).

The Fifth Circuit held that the confirmation of a plan does not substitute for a section 505 motion any more than it substitutes for an objection to a proof of claim.[122] The circuit court noted that the debtor failed to invoke the bankruptcy court's power to determine a tax debt, and the listing of the tax in his schedules, disclosure statement, and plan did not invoke that power. Thus, the debtor's plan is not res judicata with respect to the penalty (tax), and the IRS can proceed to collect it from the debtor.

(f) Effective Date

The bankruptcy court denied confirmation of a chapter 11 plan having a proposed effective date more than one year after the confirmation date for the purpose of delaying tax payments.[123] The court held that it is reasonable for the effective dates to be set on or shortly after a final confirmation order. The majority of the company's assets consist of accounts receivable valued at $3.3 million.

The court noted that the debtor sought to extend the effective date to buy extra time to collect accounts receivable and that such a situation places the risks of the plan on the taxing authorities, whose positions have worsened due to the debtor's failure to pay postpetition trust fund taxes.

(g) Dismissal of Petition

The failure to file tax returns and provide for taxes owed in a plan is often grounds for dismissal. In *Vines v. United States*,[124] the district court affirmed the dismissal of the taxpayer's bankruptcy petition on the grounds that the taxpayer failed to file tax returns and that his tax liabilities totaled more than the taxpayer could pay through a confirmable plan. The district court rejected the taxpayer's contention that I.R.C. section 6020(b) required the Treasury Secretary to file returns for him as a result of his failure to do so.

(h) Tax Impact of Trusts Created in Chapter 11

In a large number of chapter 11 cases, liquidation plans have established various funds, including liquidation trusts, for the benefit of creditors. All proceeds received from the activities usually go to the creditors. Some uncertainty has existed as to how these funds are taxed. The Supreme Court in *In re Holywell* addressed the issue and subsequent pronouncements by the IRS has helped resolve some of the issues associated with the tax impact of the establishment of these various funds. These issues, including the Supreme Court decision, are described in § 7.5(i) of this text.

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[122] *In re Taylor*, 132 F.3d 256 (5th Cir. 1998); *rehearing denied* 140 F.3d 1040 (5th Cir. 1998).

[123] *In re Potomac Iron Works*,, 217 B.R. 170 (Bankr. D. Md. 1997).

[124] 1996 U.S. Dist. LEXIS 19447 (M.D. Fla. 1996).

(i) Tax Penalty in Bankruptcy Cases

I.R.C. section 6658(a) relieves the debtor from a penalty, which otherwise might be applicable under sections 6651, 6654, or 6655, for failure to make timely payment of a tax relating to a period during which a case is pending in a bankruptcy court. The relief is limited to the extent that the bankruptcy case precludes the payment of the tax when due. In the case of a tax incurred by the estate, relief is granted if the failure occurs pursuant to an order of the court finding probable insufficiency of estate funds to pay administrative expenses. When a tax is incurred by the debtor before the bankruptcy case commences, relief is granted if the petition was filed before the due date (including extensions) for filing the return, or before the date for imposing the penalty.[125] See § 11.2(e)(i) in this text.

This relief does not apply to liability for penalties resulting from a failure to pay or deposit any employment or collected excise taxes required to be withheld by the debtor or trustee.[126]

(j) Effect of the Automatic Stay

A petition filed under the Bankruptcy Code results in an automatic stay of the actions of creditors. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or his or her property, regardless of the location of the property, until the stay is modified or removed. The stay prohibits any action to create, perfect, or enforce against the property of the debtor any lien to the extent that the lien secures a claim that arose before the commencement of the case.[127] Thus, a taxing authority is unable to take any action against the debtor to secure a prepetition tax claim by creating or perfecting a tax lien.

Initially, section 362(a)(5) of the Bankruptcy Code would prevent a taxing authority from collecting, assessing, or recovering a tax claim of the debtor that arose prior to filing the petition. If, however, the tax liability has been determined by the bankruptcy court under section 505 of the Bankruptcy Code, the IRS may assess the tax.

Under these provisions the IRS could not visit the taxpayer and ask questions regarding the debtor's business if the IRS has knowledge that the taxpayer filed a petition. In *In re William Sheldrick,*[128] the taxpayer did not list the IRS as a creditor, but the IRS learned of the bankruptcy proceedings and, in November 1987, filed a timely proof of claim for $21,566 relating to tax years 1981 through 1986. However, the court concluded that the IRS agent's visit to the taxpayer was a violation of the automatic stay. The visit was clearly prohibited by Bankruptcy Code section 362(a)(1) and constituted "an act to collect, assess, or recover a claim that arose before commencement of the bankruptcy case, in vio-

[125] I.R.C. § 6658(a)(2).
[126] I.R.C. § 6658(b).
[127] 11 U.S.C. § 362(a)(5).
[128] No. 87-01123; LEXIS, 88 TNT 149-8 (Bankr. N.D.N.Y. 1988).

lation of 362(a)(6)." The court further found that an award of attorney's fees was merited because the taxpayer was forced to commence action to enforce the rights stated under the Bankruptcy Code. However, the ability of the IRS to determine a tax liability during the bankruptcy has increased significantly with the changes made by the Bankruptcy Reform Act of 1994.

For a petition filed after October 22, 1994, the Bankruptcy Reform Act provides that an audit to determine tax liability, the issuance of a notice of tax deficiency, a demand for a tax return, and the making of an assessment for any tax and issuance of a notice and demand for payment of such assessment (however, a lien that would otherwise attach to the debtor's property will not take effect unless the tax is nondischargeable and the property or its proceeds are transferred from the estate to the debtor) is not a violation of the automatic stay. The change in the I.R.C. did not impact section 362(a)(8) of the Bankruptcy Code that provides for the stay of the commencement or continuation of a proceeding before the U.S. Tax Court concerning the debtor .The Bankruptcy Reform Act of 1994 did amend section 362(b) to provide that creation or perfection of a statutory lien for property taxes that become due after the petition is filed is not a violation of the automatic stay.

Under prior law, the taxing authority was allowed to issue to the debtor a statutory notice of tax deficiency.[129] This notice could not have been used as a demand for payment of the tax due. Under the change, the tax may be assessed resulting in a demand for the tax. Such a demand generally is considered an act to collect, assess, or recover a tax claim that arose prior to the date the petition was filed. The IRS creates a tax lien (after notice, demand, and 10 days) by recording the deficiency on a list in the District Director's office. In the case of real estate, the lien becomes public through recording of the lien in the county where the affected property is located. While the IRS can make an assessment, the subsequent recording of the lien is not allowed because such action would be viewed as an act to create, perfect, or enforce a lien against the property of the estate for a prepetition tax claim. The stay would prevent the enforcement of I.R.C. sections 6321 and 6322, which deal with a lien being placed on all property of the taxpayer at the time assessment is made.

Several courts have dealt with the impact of filing a tax lien during the period a debtor is in bankruptcy, once the debtor's petition is dismissed or terminated. For example, in *In re Ullrich*[130] the IRS assessed tax liabilities of more than $46,000 in unpaid 1992 employment taxes. After the assessment of the 1992 employment taxes, the debtor filed a chapter 13 petition in violation of the automatic stay; a Notice of Federal Tax Lien was filed. The IRS contends the Notice was computer generated by IRS Special Procedures Function. The IRS filed a proof of claim as an unsecured priority claim in the chapter 13 case. The chapter 13 case was dismissed, and two days later, a chapter 11 petition was filed. The IRS filed an amended proof of claim in the chapter 11 case and characterized the debtor's 1992 employment tax liability as a secured claim. The debtor objected to

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[129] 11 U.S.C. § 362(b)(8).

[130] 186 B.R. 747 (Bankr. M.D. Fla. 1995).

the proof of claim, contending that the notice of tax lien was filed in violation of the automatic stay in effect during the previous chapter 13 case. The bankruptcy did not allow any secured claim status.

Actions taken in violation of the automatic stay are commonly void.[131] The IRS relied on *In re Albany Partners, Ltd.*,[132] a case in which the Eleventh Circuit determined that section 362 of the Bankruptcy Code permits bankruptcy courts, in appropriately limited circumstances, to grant retroactive relief from the automatic stay. The Eleventh Circuit found in Albany Partners that because the bankruptcy petition was not filed in good faith, and because Albany Partners' asserted interest in the property was previously litigated, the court could reasonably hold the movants were reasonably entitled to rely on the previous judicial determination and proceed with the foreclosure sale on the assumption that the property was not part of the bankruptcy estate.

The bankruptcy court noted that in Ullrich, unlike in Albany Partners, there was no litigation over the issue resulting in the filing of the notice of tax lien, and no allegation that the filing was not in good faith. The court concluded that the notice of tax lien filing was void, not "avoided," and that the property that was unencumbered before the filing of the chapter 13 petition remains as such.

The Federal Circuit, however, held that an improper assessment was avoidable, but not void.[133] The IRS assessed responsible person penalties under section 6672 against Phillip Duncan Bronson one month after the bankruptcy petition was filed. The IRS's claim was excepted from the discharge order in the chapter 7 case that was converted from chapter 11. The IRS filed a notice of federal tax lien against Bronson in February 1986, and subsequently Bronson and the IRS entered into an installment agreement, where Bronson agreed to pay off the penalty and interest by making monthly payments. In addition to making payments as agreed, Bronson asked the IRS to place a lien on his home and a retirement account to enable him to pay the penalty more quickly.

In October 1987, Bronson discovered that the IRS's violation of the automatic stay might give him a basis for avoiding the assessment. After the assessment period had ended, Bronson filed a claim for refund because the IRS had violated the automatic stay. The IRS rejected his claim, and Bronson filed a complaint with the Court of Federal Claims, that ruled in favor of the IRS. On appeal, the Federal Circuit affirmed, holding that the IRS's assessment against Bronson for the I.R.C. section 6672 penalties in violation of the automatic stay was avoidable, rather than void. The court distinguished *Kalb v. Feuerstein*,[134] in which a postpetition real property foreclosure action by a state court was found to be void.

Dissenting, Circuit Judge H. Robert Mayer argued for adherence to the Supreme Court's decision in Kalb, and the principle that actions of creditors violating the automatic stay provision are void ab initio.

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[131] *Kalb v. Feuerstein*, 308 U.S. 433, 443 (1940); *Borg-Warner Acceptance Corp. v. Hall*, 685 F.2d 1306, 1308 (11th Cir. 1982).

[132] 749 F.2d 670 (11th Cir. 1984).

[133] *Bronson v. United States*, 46 F.3d 1573 (Fed. Cir. 1995).

[134] 308 U.S. 433 (1940).

In *Jim T. Spears v. United States,*[135] the IRS notified Jim Spears, in September 1985, of a proposed assessment of penalties under I.R.C. section 6672, as a responsible person of the Phoenix Energy Corporation. Spears filed a chapter 7 petition in November 1985, and a month later the IRS assessed the penalty against Spears. The IRS also filed a proof of claim in the bankruptcy proceeding for the responsible person penalties in February 1986. Also, during the period of the automatic stay, the IRS filed a notice of federal tax lien in Tulsa County. Spears received a discharge in bankruptcy in April 1986. The IRS had notice of the discharge and did not raise the issue of the validity of the assessment or the dischargeability of the tax liability in the bankruptcy proceeding.

However, the IRS did not release the tax lien on Spears's property. To obtain a loan to buy a new house two years later, Spears had to pay the assessment so that the government would release the lien. After paying the assessment, Spears filed a claim for refund, which the IRS denied.

The district court held that the assessment of a responsible person penalty during the pendency of a bankruptcy proceeding is a substantive violation of the automatic stay and is therefore void, not voidable. The court rejected the government's contention that Spears was not entitled to claim protection based on the automatic stay because he did not raise the issue in a timely manner. The court noted that since the assessment was void, Spears was not required to take any action to claim the protection of the stay.

Section 362(d) of the Bankruptcy Code provides that, for relief to be granted, a party must institute action with the bankruptcy court. The court may grant relief, after notice and opportunity for a hearing, by terminating, annulling, modifying, or conditioning the stay. The court may grant relief for cause, including the lack of adequate protection of the interest of the secured creditor. With respect to an act against property, relief may be granted under chapter 11 if the debtor does not have an equity in the property and the property is not necessary for an effective reorganization. Thus, for a governmental unit to take any action such as to assess, collect, or recover its claim against the debtor, it must file a complaint to terminate, annul, modify, or condition the stay.

An attempt by a taxing unit to collect the tax and ignore the automatic stay can have adverse consequences. For example, in *In re Daniel Demos,*[136] the District Court reversed an order of the bankruptcy court and held that the receipt of cash proceeds from insurance policies of the debtor in which the IRS had obtained a lien over 2 years earlier was in violation of the automatic stay. The court directed the IRS to turn over the proceeds to the debtor.

The Third Circuit court held that the IRS must release the refund where it had offset a prepetition tax claim against a refund for a year ending after the bankruptcy petition was filed. The court ruled that the filing of a petition acts as a stay applicable to entities and that, before the setoff can be taken, relief must be obtained under section 362(d) of the Bankruptcy Code. The intent to use the funds for setoff was sufficient evidence under Pennsylvania state law to violate

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[135] 143 B.R. 950 (Bankr. N.D. Okla. 1992). *See* 1992 U.S. Dist. LEXIS 12008 (N.D. Okla. Mar. 3, 1992).

[136] No. 85-C-1225 (E.D. Wis. 1987).

the automatic stay. Such a state law could override a federal setoff right.[137] In ruling in favor of the taxpayer, the court stated that even though some districts have local rules that permit the setoff, the practice cannot be applied universally The Supreme Court held that a bank's pre-confirmation temporary withholding of a debt that it owed a depositor who was in bankruptcy, in order to protect its set-off rights, did not violate the automatic stay. [138] This decision only overturned *Norton* to the extent that it held that "state law . . . determines when a set-off has occurred".[139] A discussion of the extent to which the decision of *Norton* is overturned by *Strumpf* is discussed in *In re Continental Airlines. See* § 10.3(k).

The district court held in *Jerri Taborski v. United States*[140] that the IRS had willfully violated the automatic stay by continuing to withhold the tax refunds that were property of the estate. The court determined that the IRS had notice of the bankruptcy proceeding and knew the stay was in force and intentionally continued to withhold the seized funds. The district court upheld the bankruptcy court's decision that required the IRS to pay the attorneys' costs and other fees of the taxpayer. The district court noted that *In re Rebel Coal Co.*,[141] a case the government urged the court in the rehearing to consider, was factually distinguishable and not instructive.

The Tax Court awarded $4,600 of administrative and litigation costs to a taxpayer that had received a prior discharge and against whom the IRS proposed a $600,000 deficiency, with interest.[142] The Tax Court questioned whether the IRS should have even issued the deficiency notice based on dubious Forms 1099-G issued by the FDIC and why the IRS had not contacted the FDIC to determine the basis of the forms.

In *Ronald J. Allison v. Commissioner*,[143] the Tax Court held that the automatic stay did not apply when a chapter 7 case is reopened. Ronald Allison filed for chapter 7 bankruptcy protection in June 1989, was granted a discharge of indebtedness in September 1989, and the case was subsequently closed. In November 1990, the IRS issued a notice of deficiency for tax year 1988. In February 1991, Allison filed a petition with the Tax Court for a redetermination of the deficiency and asked the bankruptcy court to reopen his chapter 7 case. After the bankruptcy court reopened the case, Allison filed a notice with the Tax Court to stay the deficiency redetermination under section 362(a) of the Bankruptcy Code.

The Tax Court denied Allison's request to stay the Tax Court proceeding, stating that nothing in the language of section 350(b) or 362(a) of the Bankruptcy Code authorizes a bankruptcy court to continue the imposition of the automatic stay once it has been terminated following discharge. Citing *Moody v.*

[137] *In re Norton*, 717 F.2d 767 (3d Cir. 1983).
[138] *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995).
[139] 134 F.3d 536 (3rd. Cir. 1998).
[140] 141 B.R. 959, 92-1 USTC (CCH) ¶ 50,281 (N.D. Ill. 1992), *reh'g denied*, 1992 U.S. Dist. LEXIS 6088 (N.D. Ill. 1992); *see In re Bulson*, 117 B.R. 537, 540 (Bankr. 9th Cir. 1990); *aff'd*, 974 F.2d 1342 (9th Cir. 1992); *In re Price*, 13 B.R. 259, 270 (Bankr. N.D. Ill. 1991).
[141] 944 F.2d 320 (6th Cir. 1991).
[142] *Eifert v. Commissioner*, T.C. Memo. 1997-214, 73 T.C.M. (CCH) 2736 (1997).
[143] 97 T.C. 544 (1991).

Commissioner[144] and *In re Trevino,*[145] the Tax Court noted that the ability to retain jurisdiction after a case has been closed, dismissed, or discharged does not, absent an order from the bankruptcy court, reactivate the automatic stay. The court also noted that Allison had not showed that the bankruptcy court was planning to consider the issues before the Tax Court.

The Tax Court held that a bankruptcy court order denying the taxpayers a discharge had the effect of terminating the automatic stay. The court also held that when the bankruptcy court vacated that order (after the taxpayers petitioned the Tax Court), the stay was not automatically reinstated. The Tax Court cited *Allison v. Commissioner,* 97 T.C. 544 (1991), where the Tax Court noted that the Bankruptcy Code imposes the automatic stay when a bankruptcy petition is filed but does not equate the reopening of a closed bankruptcy case with the filing of a bankruptcy petition.[146]

The Tax Court held that the automatic stay in bankruptcy is terminated on the dismissal of a bankruptcy case and is not reactivated on the case's subsequent reinstatement.[147] Judith and Carlos Guerra filed a chapter 13 bankruptcy petition in June 1992, and the case was dismissed in January 1997. On the motion of the taxpayers, the bankruptcy court vacated its dismissal order and reinstated the Guerras' case. Neither order mentioned the status of the automatic stay.

In 1997, Judith petitioned the Tax Court with respect to a 1993 deficiency that was determined by notice dated December 1996. The IRS moved to dismiss, arguing that Judith's petition violated the automatic stay on the basis that the bankruptcy court's dismissal order never became final and, alternatively, the automatic stay was reinstated when the dismissal order was vacated.

Citing *In re De Jesus Saez,*[148] the Tax Court concluded first that the bankruptcy court's dismissal order terminated the automatic stay. The Tax Court also rejected the IRS's alternative argument that the automatic stay was reinstated when the bankruptcy court reinstated the Guerras' case, citing *Kieu v. Commissioner*[149] and *Allison v. Commissioner*[150] as analogous cases. The court held in Kieu that the automatic stay is not reinstated on the reopening of a bankruptcy case in which the debtors had received a discharge. In Allison, the Tax Court held that the automatic stay was not reinstated when a bankruptcy court decided to retain jurisdiction over a case in which it had confirmed a chapter 11 bankruptcy plan.

In its argument, the IRS relied on *In re Diviney,*[151] where the bankruptcy court held that the reinstatement of a bankruptcy case causes the automatic stay to be reactivated. The Tax Court noted that the Tax Court was not obliged to find that the automatic stay was reinstated in this case and that the bankruptcy court was not without means to bring about a stay of the proceedings in this

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[144] 95 T.C. 655 (1990).
[145] 78 B.R. 29 (Bankr. M.S. Pa. 1987).
[146] *Kieu v. Commissioner*, 105 T.C. 387 (1995).
[147] *Guerra v. Commissioner*, 110 T.C. 271 (1988).
[148] 721 F.2d 848 (1st Cir. 1983).
[149] 105 T.C. 387 (1995).
[150] 97 T.C. 544 (1991).
[151] 211 B.R. 951 (Bankr. N.D. Okla. 1997) *aff'd*. 225 B. R. 762 (Bankr. 10th Cir. 1998).

Court. Other bankruptcy courts have held that the stay is reinstated on filing a subsequent petition. [152]

In *In re Helene Ulrich,*[153] Helene Ulrich and her husband, Albert Huddleston, filed a chapter 7 bankruptcy petition when the IRS issued a notice of fiduciary liability to Huddleston. Huddleston filed a Tax Court petition without first obtaining relief from the automatic stay from the bankruptcy court.

The IRS subsequently moved in the bankruptcy court for retroactive relief from the automatic stay to permit Huddleston's Tax Court case to proceed. The bankruptcy court ordered that the automatic stay be partially vacated nunc pro tunc, to authorize the Tax Court petition that was filed in violation of the stay in bankruptcy. In *Chamberlain v. Commissioner,*[154] the Tax Court previously ruled that a Tax Court petition filed in violation of the automatic stay is invalid and cannot be validated "by a modification of the stay after the fact."

In *Reagoso v. Commissioner,*[155] the IRS issued a notice of deficiency to the Reagosos for two prior tax years, and the Reagosos responded by filing a Tax Court petition while the bankruptcy petition was pending. Subsequently, the bankruptcy court issued an order of discharge and the IRS moved to dismiss the Reagosos' Tax Court petition for lack of jurisdiction, on the ground that it was filed in violation of the automatic stay.

The Tax Court ruled that the petition must be dismissed for lack of jurisdiction because section 362(a)(8) of the Bankruptcy Code prohibits a debtor from filing a Tax Court petition when the stay is in effect. The court noted that, under I.R.C. section 6213, the Reagosos had 150 days after the automatic stay was lifted in which to file a new petition because the deficiency notice was issued while the stay was in force.

The Ninth Circuit BAP held, in *In re McDaniel,*[156] that a levy by the IRS was in violation of the automatic stay because the bankruptcy court's order confirming the chapter 11 plan provided that the trust income remained the property of the bankruptcy estate after plan confirmation.

James and Barbara McDaniel filed a chapter 11 petition in 1980. The major asset of the bankruptcy estate was the income from a trust established by Barbara's parents for her benefit. The bankruptcy court previously held that the trust income was property of the bankruptcy estate. The IRS did not file a proof of claim and did not object to the plan filed by the creditors' committee, which provided for the use of the income from the trust to fund the plan. The plan provided for trust income to be paid each month to a court appointed disbursing agent for distribution. After confirmation of the plan, the IRS served a notice of

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[152] *In re Nail*, 195 B.R. 922, 925-26 and 931-32 (Bankr. N.D. Ala. 1996) (chapter 13 case, stay reinstated); *In re Bennett*, 135 B.R. 72 (Bankr. S.D. Ohio 1992) (creditor seems to have assumed such a reinstatement reimposed the stay); *but see In re Burke*, 198 B.R. 412, 416 (Bankr. S.D. Ga. 1996), (reopening simply did not reimpose stay).

[153] No. 88-10415-B (Bankr. E.D. La. Nov. 9, 1992).

[154] Tax Ct. No. 29771-89 (July 19, 1991).

[155] 66 T.C.M. (CCH) 850 (1993). *aff'd* 39 F.3d 1171 (3rd Cir. 1994).

[156] BAP No. SC 92-1749-JERO (Bankr. 9th Cir. 1993).

levy on the disbursing agent, seeking to collect the McDaniels' outstanding income taxes. The levy was to attach only to that portion of the distribution from the trust allowed for the McDaniels' use. The disbursing agent paid some funds to the IRS under the levy and the McDaniels protested.

The bankruptcy court held that all funds in possession of the disbursing agent were property of the estate and that the IRS violated the automatic stay by levying on the funds. The bankruptcy court noted that section 106(c) of the Bankruptcy Code operates as a waiver of sovereign immunity. The IRS appealed.

As noted above, the BAP held that the trust income was estate property and that the IRS must therefore refrain from future levies against the trust income. The BAP, however, held that sovereign immunity precluded the bankruptcy court from ordering the IRS to return the levied funds.

The automatic stay may be applicable even though it is subsequently determined that the bankruptcy petition is invalid because it was improperly filed, as was the case in *Wekell v. United States.*[157]

Connie Wekell and her husband were divorced in 1987; prior to their divorce, Wekell's husband filed for bankruptcy in both their names. A tax lien was filed on Wekell's property after the automatic stay was lifted. Connie Wekell removed the tax lien on the basis that the statute of limitations had expired.

Wekell said that she had not consented to the bankruptcy filing and that her husband, when he filed for bankruptcy in her name, acted through an unnotarized power of attorney he had extracted from her. The district court held that the automatic stay went into effect even though the filing of the bankruptcy petition was ultra vires. On appeal, the Ninth Circuit affirmed the district court's decision. The creditors noted that creditors are required to observe the automatic stay, and that they are entitled to rely on it unless and until it is found invalid. The Ninth Circuit concluded: "The simple rule is also the fairest: so long as a person is listed as a debtor in a bankruptcy petition, everyone involved is entitled to count on the automatic stay."

In *In re Kroll,*[158] the district court affirmed a bankruptcy court's rejection of Louis and Helen Kroll's request in a chapter 13 case to turn the residence over to the bankruptcy estate that was seized prepetition. The court approved a motion filed by the IRS to lift the automatic stay in order to proceed with an administrative sale of the Krolls' residence. The bankruptcy court determined that the Krolls lacked any equity in the property as a result of the federal tax lien. The court also ruled that the IRS's interest was not adequately protected and that the property was not necessary for a legitimate plan of reorganization. The district court noted that if the property is of inconsequential value or benefit to the estate, no useful purpose will be served by turning the property over to the estate.

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[157] 14 F.3d 32 (9th Cir. 1994).

[158] 1994 U.S. Dist. LEXIS 11851, 74 A.F.T.R.2d (RIA) 6161 (W.D. Mich. 1994).

The automatic stay is not applicable to a partner that has not filed a petition, and as a result the IRS is free to collect any tax that may have been assessed against that partner. In *United States v. Wright*,[159] the district court held that the government's collection action against the Wrights as partners of Empire Wood, a partnership that was in bankruptcy, was barred by the statute of limitations. The assessments were made in 1982 and 1983 and in 1993 the government initiated action to collect the tax. The court noted that the government's arguments concerning the tolling of the statute of limitations during the bankruptcy period failed to distinguish between its authority to pursue a collection action against the taxpayer, Empire Wood, and its authority to pursue persons allegedly liable for the payment of the taxes. The bankruptcy of the entity primarily responsible for the tax is not applicable to the individual that may be responsible for paying the tax. The court concluded that the statute of limitations was tolled with respect to collections against the company but the government remained free to pursue collection from the Wrights.

The district court held that an order granting the IRS retroactive relief from the automatic stay validated a postpetition assessment that otherwise would have been void as a violation of the stay.[160]

The taxpayers entered into a closing agreement with the IRS in November 1992 and filed a chapter 13 petition in December. Two months later, the IRS assessed the tax liabilities covered by the closing agreement. Admitting that the assessment violated the automatic stay, the IRS sought and obtained from the bankruptcy court retroactive relief from the automatic stay.[161] The district court affirmed, concluding that the bankruptcy court's grant of retroactive relief under section 362(d) of the Bankruptcy Code effectively validated acts that would have otherwise been void.

The Tax Court held that a bankruptcy court's order of dismissal terminated the automatic stay in a couple's bankruptcy case. Thus the dismissal allowed the couple's two Tax Court cases to be restored to the general docket for trial. The Tax Court noted that the bankruptcy court's decision to dismiss the case, while retaining jurisdiction, did not provide a basis for concluding that the automatic stay remains in effect. The Tax Court also found it particularly significant that the order makes no mention of the status of the automatic stay.[162]

In *In re Haedo*,[163] the bankruptcy court refused to lift the automatic stay in a chapter 11 case to allow the government to set off a couple's postpetition tax refund against substantial section 6672 penalties assessed against the couple, because the refund may have partially belonged to the wife, who did not file. The bankruptcy court disagreed with the government position that the refund is not property of the estate, pointing out that courts have uniformly held that at

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[159] No. IP 93-1402 C (S.D. Ind. July 15, 1994).

[160] *In re Siverling*, 179 B.R. 909 (Bankr. E.D. Cal. 1995), *aff'd* 77 A.F.T.R.2d (RIA) 1067, 96-1 U.S. Tax Cas. (CCH) P50134 (E.D. Cal. 1996).

[161] *Id*.

[162] *Zaklama v. Commissioner*, T.C. Memo, 1995-587.

[163] 1997 Bankr. LEXIS 502, 79 A.F.T.R.2d (RIA) 2340 (Bankr. S.D.N.Y. Apr. 7, 1997).

least some portion of the refund pertaining to the year of filing is property of the estate.

The bankruptcy court held that the IRS violated the automatic stay by levying on abandoned assets after the debtor received a discharge but before the bankruptcy case was closed. However, the court refused to impose damages because the debtor suffered no injuries.[164] The court disagreed with *In re Walker*[165] and *In re Debeaubien*[166] that property is abandoned when a trustee files an abandonment report, concluding that property is not abandoned under 11 U.S.C. section 554(c) until a case is closed.

A district court held that the IRS violated the automatic stay in a corporation's bankruptcy case by willfully selling the debtor's property, and ordered the IRS to pay damages and attorney's fees.[167] Hanna Coal Company, Inc., filed for bankruptcy in 1989, and before July 1990 the IRS levied on equipment held by PSB Mining, another coal company, to satisfy PSB's outstanding tax liability. The IRS sold the equipment in September 1990 even though Hanna notified the IRS that it owned the equipment and that it was in bankruptcy. The IRS proceeded with the sale based on PSB's assertions that it owned the property and on depreciation schedules submitted by PSB.

The district court concluded, "Knowing that PSB's ownership of the equipment was questionable, and that the potential true owner had filed for bankruptcy, section 362 required the IRS to respect Hanna's automatic stay." Determining that the equipment had a $24,000 value, the court awarded damages in that amount, plus attorney's fees.

The district court[168] lifted a chapter 13 automatic stay to permit the IRS to appeal a finding in a prior chapter 7 proceeding that an individual's tax liabilities were dischargeable. The district court determined that the bankruptcy court abused its discretion by not lifting the automatic stay. The court noted that if the IRS succeeds on appeal, the taxpayer will have debts in excess of the unsecured debt limit under chapter 13 and will be ineligible for that protection. The government has a due process right to appeal the bankruptcy court's discharge ability determination before confirmation of a repayment plan renders its appeal moot.

(k) Tax Offset

Bankruptcy Code section 553 allows a creditor to offset a claim against a debt the creditor owes to the bankrupt. At the time the petition is filed, there is an automatic stay that prevents an immediate setoff. The right of setoff exists and, with the approval of the court, the actual setoff may take place. See § 10.3(m) for a discussion of the right of the debtor to offsets. This right also applies to taxes.

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[164] *In re Weisberger*, 205 B.R. 727 (Bankr. M.D. Pa. 1997).
[165] 151 B.R. 1006 (Bankr. E.D. Ark. 1993).
[166] 27 B.R. 713 (Bankr. E.D. Tenn. 1983).
[167] *Hanna Coal Co. v. IRS*, 218 B.R. 825 (W.D. Va. 1997).
[168] *Weiss v. United States*, 2000 U.S. Dist. LEXIS 10663 (E.D. Pa. 2000).

For the IRS to have the right to offset a tax refund against a liability of a taxpayer, the IRS must prove that:

- The IRS has a claim against the debtor that arose before the bankruptcy filing;
- The IRS owes a debt to the debtor that arose before the bankruptcy filing;
- The claim and debt are mutual obligations.[169]

In *John E. Sanford III v. Commissioner*,[170] the Tax Court held that Sanford's Tax Court petition was not filed in violation of the automatic stay because it was filed after the bankruptcy court had entered an order discharging Sanford from all dischargeable debts. The court noted that "the automatic stay was terminated on that date [discharge] by virtue of the express terms of 11 U.S.C. section 362(c)(2)(C)."

The right to the portion of a tax refund that accrued prepetition is property of the bankruptcy estate even though the tax year has not ended. The fact that the refund amount does not become fixed until the end of the tax year does not limit the broad applicability of section 541(a) of the Bankruptcy Code.[171] Courts generally have held that the right to a tax refund arises at the end of the tax year to which the refund relates.[172]

It is not necessary to determine the amount of the debt owed to the debtor prior to the bankruptcy filing in order for setoff to be available to the creditor.[173] For example, if a bankruptcy petition is filed by a calendar-year taxpayer on February 2, the tax refund would be considered prepetition even though the tax refund is not due until April 15.

The courts are not in agreement as to the question of whether it is proper to allow setoff when a chapter 11, 12, or 13 plan provides for full payment of the tax claim.

The bankruptcy court in *United States v. Johnson*[174] noted that a number of courts, in factually distinguishable cases, have held that the IRS can set off a prepetition tax refund with a prepetition tax obligation after the bankruptcy petition is filed.[175]

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[169] *See Braniff Airways, Inc. v. Exxon Co., U.S.A.*, 814 F.2d 1030, 1035 (5th Cir. 1987).

[170] T.C.M. (CCH) 2571 (1992)

[171] *In re Doan*, 672 F.2d 831, 833 (11th Cir. 1982); *see generally Segal v. Rochelle*, 382 U.S. 375 (1965), 86 S. Ct. 511, 15 L.Ed.2d 428 (1966) (potential claims for loss carryback tax refund realized after the end of year in which taxpayer files bankruptcy petition, for losses suffered prior to petition filing, are property of the bankruptcy estate).

[172] *In re Harbaugh*, 1989 WL 139254 (W.D. Pa. 1989), *aff'd*, 902 F.2d 1560 (3d Cir. 1990); *In re Rozel Industries, Inc.*, 120 B.R. 944, 949 (Bankr. N.D. Ill. 1990); *In re Ferguson*, 83 B.R. 676, 677 (Bankr. E.D. Mo. 1988); *In re Mason*, 79 B.R. 786, 787 (Bankr. N.D. Ill. 1987); *In re Dominguez*, 67 B.R. 526, 528 (Bankr. N.D. Ohio 1986).

[173] *Braniff Airways, Inc. v. Exxon Co., USA*, *supra* note 169 at 1036.

[174] 136 B.R. 306 (Bankr. M.D. Ga. 1991).

[175] *See* cases cited *supra* note 171: *In re Harbaugh*, 1989 WL 139254 (chapter 7 case); *In re Rozel Industries, Inc.*, 120 B.R. at 951-52 (chapter 11 case); *In re Ferguson*, 83 B.R. at 677-78 (chapter 13 case); *In re Mason*, 79 B.R. at 788 (chapter 13 case); *In re Dominguez*, 67 B.R. at 529 (chapter 13 case. *See also Still v. United States In re W.L. Jackson Mfg. Co.*). 50 B.R. 506, 508 (Bankr. E.D. Tenn. 1985) (chapter 11 case that converted to chapter 7).

In *In re Mason*,[176] it was held that a creditor who has a right of setoff does not forfeit that right upon confirmation in the chapter 13 plan. However, in *In re Crabtree*,[177] the bankruptcy court held in a chapter 11 case that the IRS has no right of setoff after confirmation when the plan provides for payment of the tax obligation.

In *Norton*,[178] the court refused to allow the setoff. The bankruptcy court gave the IRS notice and an opportunity to have its objections to the proposed plan heard. The IRS did not object to the plan. The Third Circuit held that, upon confirmation, the IRS became bound to that plan and to the payment schedule that would satisfy its claim in full. The court noted that to allow the IRS to retain an overpayment as extra security on the debt would seriously compromise the powers of the bankruptcy court, the capacity of debtors to rehabilitate, and the equitable distribution that the Bankruptcy Code is designed to foster.[179]

In *In re Gribben*,[180] the district court vacated the bankruptcy court's ruling that, because the IRS had offset the refunds without first seeking relief from the automatic stay, the offset was void. The bankruptcy court had concluded that the intervening determination of dischargeability eliminated the IRS's claim so that an offset was no longer possible. The district court noted that the right of offset is very much favored by the Bankruptcy Code because it would be unfair to permit the debtor to collect all debt owed to him or her while refusing to recognize the debtor's debts to others.

In *In re Rush-Hampton Industries*,[181] the bankruptcy court allowed the corporation to offset its 1978 federal income tax liability for $43,893 in taxes and $48,457 in interest against a request for refund due to an overpayment of tax. The government did not request a relief from the stay before making the offset.

The court declined to allow the IRS's offset of postpetition interest because to do so would "reward the IRS for offsetting prior to receiving relief from the automatic stay." However, the Eleventh Circuit[182] saw it differently and vacated the decision and remanded for reconsideration of the denial of the right to setoff the postpetition interest, holding that appellant would have been entitled to such setoff if it had timely moved to lift the stay.

The district court concluded that 11 U.S.C. section 553 preserved the IRS's right to offset if the overpayment and the underpayment arose prepetition. The court rejected the trustee's contention that the refund was owed to the estate and not the prepetition debtor and, therefore, that the debts lacked mutuality and the IRS had no right of offset. The court reasoned that the right to refund accrues on the last day of the taxable year, so that the right to the refund accrued to the prepetition debtor.

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[176] 79 B.R. at 788.
[177] 76 B.R. 208, 210 (Bankr. M.D. Fla. 1987).
[178] *In re Norton*, 717 F.2d 767 (3d Cir. 1983).
[179] *Id.* at 774.
[180] 158 B.R. 920 (S.D.N.Y. 1993).
[181] 159 B.R. 343 (Bankr. M.D. Fla. 1993).
[182] *In re Rush-Hampton Industries*, 98 F.3d 614 (11th Cir. 1996).

In *In re Dowdle*,[183] the bankruptcy court granted Dowdle's motion to recover the offset refund when the IRS applied John Dowdle's 1992 tax refund to his 1993 federal income tax liability. Within 90 days, Dowdle filed a bankruptcy petition. He filed a motion to recover the offset refund on the basis that the government's seizure of his property within 90 days of his bankruptcy petition must be set aside. The IRS moved to dismiss Dowdle's motion, arguing that the government had not waived sovereign immunity. The bankruptcy court noted that the IRS had not filed a proof of claim against Dowdle, but that he had initiated the action.

A district court[184] has reversed a bankruptcy court's decision that accepted an administrative freeze placed by the IRS on a couple's tax refund because of the ruling in *Citizens Bank of Maryland v. Strumpf*.[185] Under the Supreme Court ruling, the district court noted, the retention of property subject to a right of setoff does not violate the automatic stay, at least so long as the creditor acts diligently in seeking relief from the stay to enforce its right. The case was remanded for the lower court to determine the basis on which the IRS proceeded in this case. On remand the bankruptcy court determined that the IRS violated the automatic stay under section 362(a)(3) by freezing the debtors' tax refund.[186] The district court affirmed the bankruptcy court's judgment and determined that the refund was property of the bankruptcy estate and the unauthorized control exercised by IRS by placing a freeze violated section 362(a)(3). It concluded that an award of damages for emotional distress was appropriate.[187]

In *In re Hudson,*[188] the bankruptcy court held that the automatic stay does not prohibit the collection of a postpetition debt from postpetition property of the debtor. Thus, the court explained that it was not necessary for the IRS to get relief from the stay to pursue collection of the postpetition debt from Hudson.

In *United States v. Reynolds*[189] (another chapter 13 case), the IRS did not object to the confirmation of the plan. Later, it filed a proof of claim and set off the tax refund by the amount of the tax obligation. The Fourth Circuit stated:

> [T]he IRS violated the automatic stay and that the Reynoldses' plan provided for payment of the 1979 tax liability as a priority claim, binding the IRS to accept it. On appeal, the district court, after granting the motion of the chapter 13 trustee to intervene, affirmed on the same grounds. The court added that although the IRS was a secured creditor, by virtue of its right of setoff under 11 U.S.C. section 553(a) (1982), the Reynoldses could recover the portion of the refund retained by the IRS because the confirmed bankruptcy plan provided "adequate protection" of the IRS's security interest, 11 U.S.C. sections 361, 362(d)(1) (1982).[190]

[183] 164 B.R. 43 (Bankr. M.D. Pa. 1994).
[184] *In re Holden*, 217 B.R. 161 (D. Vt. 1997), 258 B.R. 323 (D. Vt. 2000).
[185] 516 U.S. 16 (1995).
[186] *In re Holden*, 236 B.R. 156 (Bankr. D. Vt. 1999).
[187] *United States v. Holden*, 2000 U.S. Dist. LEXIS 12825 (D. Vt. 2000).
[188] 168 B.R. 448 (Bankr. S.D. Ga. 1994).
[189] 764 F.2d 1004 (4th Cir. 1985).
[190] 764 F.2d at 1006.

Two Circuit Courts[191] have held that the application of setoff is permissible, not mandatory, and lies within the equitable discretion of the court. A similar decision was reached in *United States v. Johnson.*[192]

Vivian Johnson filed a chapter 13 petition in March 1991, and her plan, which was confirmed in July 1991, provided that her outstanding 1987 tax obligation of $1,828 was to be paid in full as a classified unsecured priority claim. The IRS filed its claim asserting a right to setoff of the 1987 obligation.

Johnson filed her 1990 tax return in April 1991, postpetition but preconfirmation, and was due to receive a refund of $1,550. The government asserted that, under Bankruptcy Code section 507, it had an unsecured priority claim for $278 (which Johnson did not dispute), and a secured claim of $1,550. In August 1991, the government filed a motion to lift the automatic stay to set off the 1990 tax refund against Johnson's 1987 tax obligation. However, Johnson asked that the court allow her to repay her obligation using her confirmed plan and that it order the IRS to issue the refund.

The bankruptcy court denied the government's motion, but ordered that Johnson demonstrate that the government's claim would be protected before a refund check was issued. The court held that the IRS claim against Johnson arose before the bankruptcy filing and that a portion of the tax refund that accrued prepetition was property of the bankruptcy estate even though the tax year had not ended, making both the claim and refund mutual obligations.

The court was unable to determine whether it was proper to allow setoff when the confirmed chapter 13 plan provides for full payment of the tax obligation. Therefore, the court ordered a hearing to consider whether Johnson could demonstrate that the IRS would be adequately protected should the court rule not to allow the IRS to offset the claim.

Thus, the court was persuaded that the debtor would provide adequate protection before the IRS was required to issue a refund check. The presumption is made that if the creditor is adequately protected, the setoff will not be allowed.

In *In re Sound Emporium,*[193] the court allowed the IRS to offset a subordinate claim against debt owed by the U.S. Army to the bankrupt debtor. In a chapter 13 case,[194] the court held that a tax refund due to postpetition overpayments could not be offset against a prepetition chapter 13 tax claim that was approved in the plan. In *Dominguez,*[195] the IRS was allowed to offset a prepetition tax refund against a prepetition dischargeable liability.

A chapter 11 debtor is not entitled to offset its claim for overpaid employment taxes for five years against the Service's proof of claim, because the debtor's overpayment claim was untimely. While the bankruptcy court rejected the Service's position that the taxpayer failed to make a claim for refund or credit on the basis that the taxpayer sought the credits only as an offset to the

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[191] *In re Southern Industrial Bank Corp.*, 809 F.2d 329, 332 (6th Cir. 1987); *In re Norton*, 717 F.2d at 772, *supra* note 178.

[192] *Supra* note 174.

[193] 84-2 USTC (CCH) ¶ 9950 (Bankr. W.D. Tex. 1984).

[194] *In re A.E. Burrow*, 84-2 USTC (CCH) ¶ 9758 (D.C. Utah 1984).

[195] 67 B.R. 526 (Bankr. D.C. Ohio 1986).

Service's proof of claim, and no request for a refund had to be made, the court concluded that any claim for credit regarding the taxpayer's 1986-1990 quarterly taxes was untimely under section 6511 of the Internal Revenue Code.[196]

The bankruptcy court held that the Education Department violated the automatic stay when it offset the taxpayer's $537 refund check against a prepetition student loan.[197] The court ordered the Department of Education to return the refund and pay the attorney's fees of $450.

In *United States v. Chapter 11 Trustee of Combined Thoroughbred Agencies*,[198] the district court affirmed a decision of the bankruptcy court that held that the government was not entitled to a setoff of a tax refund against a penalty. The bankruptcy court found that the penalty was an unsecured claim without priority because it was not a compensation for pecuniary loss; therefore, permitting a setoff would be inequitable to the unsecured creditors. The bankruptcy court ruled that the IRS had violated the automatic stay by setting off the refund against the penalty without court approval. The bankruptcy court also held that the government had waived its right to a setoff by failing to assert a setoff when it filed a proof of claim.

The district court noted that, although setoffs are encouraged in appropriate circumstances, the denial of preference is appropriate where the debt does not reflect a pecuniary loss to the government. The court held that, because the government admitted that the penalty was not the result of a pecuniary loss, the government had no right to setoff.

In *In re Pettibone Corp.*,[199] Pettibone Corp. both overpaid and underpaid its tax liability in substantial amounts over a number of years. Pettibone filed for chapter 11 and included in the reorganization plan the method of calculating the company's total tax and interest liability as approved by the bankruptcy court. On appeal, Pettibone asked the district court to determine whether the accounting method used by the IRS and approved by the bankruptcy court was an allowable method of dealing with the overpayments and underpayments and applicable interest.

The IRS offset earliest overpayments against earliest underpayments, and calculated the interest earned on the overpayments from the date the overpayment was made until the date the underpayment was due. The district court affirmed the bankruptcy court's conclusion that the IRS's method of offsetting the taxes and interest from Pettibone's over- and underpayments was proper. The district court rejected the bankruptcy court's determination that the debts were nonmutual by noting that the IRS's attempt to offset its liability to Pettibone by the amounts owed the IRS was an indication of mutual debt. The district court concluded that the IRS was not performing setoffs within the meaning of the Bankruptcy Code.

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[196] *In re Dunhill Medical, Inc.*, 1996 Bankr. LEXIS 435 (Bankr. D.N.J. 1996).
[197] *In re Blake*, 1998 Bankr. LEXIS 1515; 82 A.F.T.R.2d (RIA) 7343 (Bankr. D. Md. 1998).
[198] 1991 U.S. Dist. LEXIS 16731 (E.D.N.Y. 1991).
[199] 161 B.R. 960 (N.D. Ill. 1993).

In *Pettibone Corp. v. United States*[200] the Seventh Circuit has affirmed the district court judgment to allow the continuous offsetting. The Circuit Court agreed with the district court's characterization of the netting of tax overpayments and underpayments as an accounting method, not the type of setoff or offset contemplated by the Bankruptcy Code. The Court noted that unless the parties have distinct obligations to each other, the concept of "setoff" makes no sense. As discussed in § 11.2(h) of this text, the Appeals Court remanded with directions for the lower court to reduce the judgment due to a change in the method of calculating the interest.

Because the taxing authority's right to effect the setoff arose before the bankruptcy commenced, the bankruptcy court held that its rights were unaffected by the Bankruptcy Code.[201] The court noted that since a taxing authority's obligation to pay a refund arises on the last day of the tax year, state department of revenue properly offset of a refund for 1999 against a liability for 1994, given that the taxpayer did not file his bankruptcy petition until April 10, 2000, and did not file his state tax return for 1999 until April 17, 2000.

After filing her bankruptcy petition, the debtor filed her income tax return for the prior year which entitled the debtor to a refund of overpaid taxes. Although the debtor's prior tax debt was then discharged, the IRS setoff the debtor's tax refund against her debt. The debtor then listed the overpayment as an exempt asset and claimed that the refund was not subject to setoff. The appellate court first held the statutory injunction against efforts to collect a discharged debt did not affect the IRS' statutory right to setoff.[202] The overpayment owed by the IRS to the debtor arose prepetition, at the end of the tax year, regardless of when the debtor filed her return. The Fifth Circuit also held that the overpayment was not subject to exemption since the debtor's right to the refund was limited to the amount exceeding her tax liability; since her liability exceeded the overpayment, the overpayment never became an asset of the estate subject to exemption.

A setoff is not considered a levy under I.R.C. section 6703(c)(1). In *David L. Morgan v. United States*,[203] the district court held that the setoffs did not constitute a levy prohibited by I.R.C. section 6703(c)(1). The court noted that a levy would involve an IRS action to acquire possession of a taxpayer's property; a setoff is the application of funds already in the government's possession against a taxpayer's outstanding tax liability.

The Ninth Circuit held that for purposes of waiver of sovereign immunity and setoff under section 106(b) of the Bankruptcy Code, all agencies of the United States, except those acting in some distinctive private capacity, are a single governmental unit. Therefore, the court concluded, if a person prevailed against the United States on their tort claims against the FBI, the IRS's claims

[200] 1994 U.S. App. LEXIS 24273 (7th Cir. 1994).
[201] *In re Ramirez*, 266 B.R. *441* (Bankr. D. Minn., September 12, 2001).
[202] *In re: Luongo*, 259 F.3d 323 (5th Cir. 2001).
[203] 1991 U.S. Dist. LEXIS 11810 (E.D. Ark. 1991).

against their bankruptcy estate may be reduced by the amount of their tort judgment.[204]

The Ninth Circuit noted that section 106(b) of the Bankruptcy Code provides, "There shall be offset against an allowed claim or interest of a governmental unit any claim against such governmental unit that is property of the estate." The Ninth Circuit accepted the United States' contention that "governmental unit" refers to the United States as a whole, rather than to particular agencies. The court stated that the United States reaches this position out of a commendable sense of fairness and reciprocity because it often seeks to be treated as a single unitary creditor under the offset provisions of section 553 of the Bankruptcy Code.

The Ninth Circuit Bankruptcy Appellate Panel held that federal agencies, except those acting in a distinctly private capacity, are a single entity for purposes of setoff under section 553 of the Bankruptcy Code.[205] Hawaiian Airlines, Inc., filed a chapter 11 petition, and it was subsequently determined that Hawaiian Airlines overpaid its federal air transportation excise taxes. The bankruptcy court, having previously held that the United States is a unitary creditor, allowed the U.S. government to offset the Hawaiian Airlines tax overpayment against prepetition claims of other federal agencies. The Bankruptcy Appellate Panel for the Ninth Circuit agreed.

(l) Assignment of Tax Refunds

For companies that have previously operated successfully but are currently sustaining operating losses, the claim for a tax refund may be used as additional security for an existing loan or as collateral for a new loan. Where a bankruptcy petition is filed prior to the time the tax is paid, it is not clear whether the debtor-in-possession (trustee) or the lender is entitled to the refund.

At least two issues are important in determining who is entitled to the tax refund. First, it must be ascertained whether state or federal law dealing with perfecting of interest applies. State laws are based on the Uniform Commercial Code, but section 9-104 provides that the code is not applicable to certain transactions, including those where the security interest is subject to a statute of the United States. If held applicable, the statute that applies is the Federal Assignment of Claims Act (Claims Act).[206] Under this statute, it would be difficult to protect a security interest in a tax refund, because an assignment cannot be filed until the claim has been allowed in an amount certain and a warrant has been issued for its payment. In *Martin v. National Surety Co.*,[207] the Supreme Court held that the transfer of funds after payment had been made by the government was of no concern to the government but only to the parties involved in the transaction. This case involved an assignment of a claim of a contractor who had

[204] *In re Doe*, 58 F.3d 494 (9th Cir. 1995).
[205] In *re HAL, Inc.*, 196 B.R. 159 (Bankr. 9th Cir. 1996) *aff'd* 122 F.3d 851 (9th Cir. 1997).
[206] 31 U.S.C. ¶ 203 (1954).
[207] 300 U.S. 588 (1937).

not filed a bankruptcy petition, but the applicability of the Claims Act would not be different.[208] In two subsequent cases, the Supreme Court reaffirmed its basic holding in *Martin*.[209] The decision in *Martin* did, however, differ from the Supreme Court's ruling in *National Bank of Commerce v. Downie*.[210]

The second issue, once it has been determined that state and not federal law applies, is the time of the assignment of the refund. In *In re Ideal Mercantile Corp.*,[211] the Second Circuit's Court of Appeals held that, because the customary refunds claim had not been allowed or paid at the time the bankruptcy petition was filed, the Claims Act was still applicable. Because there was no compliance with the Claims Act, the assignment of claims was not perfected and was made immediately before the petition. Thus, under prior law (Bankruptcy Act), this assignment was an act of bankruptcy. Commitment of an act of bankruptcy is no longer an issue under the Bankruptcy Code, but the timing of the selection of a security interest is.

The Ninth Circuit took a different view from that of the Second. It held in *In re Freeman*[212] that the assignment of the entire tax refund by the wife to the husband in a divorce settlement was dependent on local law and that, under California law, a future right could be assigned. Also, the court held that the date of assignment of the claim is the date to use, not the date the claim was paid.[213]

It should be realized that these cases were under the Bankruptcy Act. In addition to the conflict between the Circuit Courts, the problem of this assignment being a preference if it is for an antecedent debt is further complicated by section 547(e)(3) of the Bankruptcy Code, which states that a "transfer is not made until the debtor has acquired rights in the property transferred." It has been held that a right is not acquired in a situation involving a carryback of a tax loss until the end of the tax year in which the loss occurred.[214] Thus, if the debtor files for a refund more than 90 days prior to the petition date and immediately assigns this right to a creditor, and if the claim is allowed and paid after the petition is filed, it is not clear how the courts will rule on the ability of the debtor to transfer this right prior to the filing of the petition.[215]

One other case of interest is *In re Lagerstrom*,[216] wherein the debtor assigned his 1968 income tax refund to his attorney one month prior to bankruptcy. The attorney failed to file a financial statement. The court ruled that the transaction was not meant to create a security interest, but was attempting to make an outright conveyance of the refund to his attorney. Thus, in certain cases, it may be

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[208] *Id.* at 595.
[209] *Segal v. Rochelle*, 382 U.S. 375 (1965); *United States v. Shannon*, 342 U.S. 288 (1952).
[210] 218 U.S. 345 (1950). *Id.* at 433.
[211] 244 F.2d 828 (2d Cir. 1957).
[212] 489 F.2d 431 (9th Cir. 1973).
[213] *Id.*
[214] *Segal v. Rochelle*, *supra* note 209.
[215] For a more detailed discussion on the assignment of tax refunds, *see* Novick and Seif, Perfecting Security Interests in Federal Tax Refund Claims, 12 *U.C.C.L.J.* 34 (1979).
[216] 300 F. Supp. 538 (N.D. Ill. 1969). *See In re Sturgis Printing Co.*, 1 Bankr. Ct. Dec. (CRR) 1338 (Sept. 18, 1975).

better to seek and obtain conveyance of the tax refund rather than take a security interest.[217] The bankruptcy court in *In re David Paul Johnson*[218] held that a tax refund that was no part of a plan is not property of the estate and is not subject to the automatic stay. The court would not set aside the right to the tax refund that had been obtained by the state of Utah's Department of Social Services.

(m) Waiver of Sovereign Immunity

Section 106 of the Bankruptcy Code provides that a governmental unit (federal, state, local, etc.) is deemed to have waived sovereign immunity with respect to any claim against itself which is property of the estate and which arose from the same transaction or occurrence that resulted in the governmental unit's claim. Legislative history indicates that the filing of a proof of claim against the estate by a governmental unit is a waiver of sovereign immunity with respect to compulsory counterclaims arising from the same transaction or occurrence. Thus, the governmental unit cannot receive a distribution from the estate without subjecting itself to liability.[219]

Effective October 22, 1994, section 106 of the Bankruptcy Code is modified to expressly provide for a waiver of sovereign immunity by governmental units with respect to monetary recoveries as well as declaratory and injunctive relief. The waiver does not, however, apply to punitive damages. The changes to section 106 of the Bankruptcy Code will overrule two Supreme Court cases that have held that the states and federal government are not deemed to have waived their sovereign immunity by virtue of the prior provisions of section 106(c) of the Bankruptcy Code. For example, the Supreme Court, in *Hoffman v. Connecticut Department of Income Maintenance*,[220] held that even if the state did not file a claim, the trustee in bankruptcy may not recover a money judgment from the state notwithstanding section 106(c). Thus, a preference could not be recovered from the state. In *United States v. Nordic Village, Inc.*,[221] the Supreme Court held that a trustee could not recover a postpetition payment by a chapter 11 debtor to the IRS.

Section 106(d) is clarified by the Bankruptcy Reform Act of 1994 to allow a compulsory counterclaim to be asserted against a governmental unit only where such unit has actually filed a proof of claim in the bankruptcy case. On the signing of the Bankruptcy Reform Act of 1994 by the President, the modifications to section 106 of the Bankruptcy Code are effective regardless of when the petition was filed.

[217] Novick and Seif, *supra* note 215 at 46.
[218] 36 B.R. 956 (Bankr. Utah 1983).
[219] S. Rep. No. 989, 95th Cong., 2d Sess. 29, 30 (1978). In *In re Community Hospital of Rockland County*, 5 B.R. 11 (D.C.N.Y. 1980), it was held that the bankruptcy court lacks jurisdiction to hear the debtor's complaint when the government has not filed a proof of claim, even though the government was listed as a creditor in schedules filed with the court.
[220] 492 U.S. 96 (1989).
[221] 112 S.Ct. 1011 (1992).

Service filed proof of claim based on unpaid taxes, which also were the basis for prepetition levies against a third party.[222] The debtor objected that the nominee/alter ego liability levies were wrongful, and the bankruptcy court agreed. The district court reversed, upholding the Government's argument that there is no waiver of sovereign immunity for a wrongful levy action in bankruptcy. The court found that section 106 of the Bankruptcy Code creates no independent waiver of immunity, nor does the Service waive immunity by filing a claim in the bankruptcy. The court also found that I.R.C. section 7526(a)(1) did not give the debtor standing to challenge nominee/alter ego status on behalf of a third party.

In *Odessa H. Taylor v. United States,*[223] the district court affirmed the bankruptcy court's decision that the waiver of sovereign immunity provided for in section 106(a) of the Bankruptcy Code was triggered by the government's "right to payment"—by the "existence" of the claim—regardless of whether the government had filed a claim. The court noted that to decide otherwise would, in effect, allow the government to receive payment on a claim without waiving sovereign immunity, whereas the mere filing of a claim would constitute a waiver.

Section 106(b) of the Bankruptcy Code provides that the debtor may offset against the allowed claim of a governmental unit, up to the amount of the allowed claim, any claim of the debtor against the governmental unit. This is without regard to whether the claim arose from the same transaction or occurrence.

Section 106 of the Bankruptcy Code also permits the bankruptcy court to determine the amount and dischargeability of tax liabilities or other claims owed by the debtor prior to or during a bankruptcy case, whether or not the governmental unit has filed a proof of claim. In addition, legislative history indicates that the authority of the bankruptcy court over governmental units is not limited to tax or other governmental claims. The court is permitted to bind the government on other matters such as allowing the debtor-in-possession or trustee to assert avoidance powers provided for in a bankruptcy case against a governmental unit.[224]

In *In re VN. DePrizio Construction Co.,*[225] the bankruptcy court allowed the debtor to recover four payments made to the IRS as preferences. The United States asked the court to reconsider that summary judgment, arguing that the government did not waive its sovereign immunity in the proceeding by filing its prepetition tax claims. The bankruptcy court denied the government's motion to reconsider, concluding that the government waived its sovereign immunity pursuant to 11 U.S.C. section 106(a). The bankruptcy court noted that under I.R.C. section 106(a), the United States is deemed to have waived sovereign immunity with respect to any claim against it that is property of the estate and that arose

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[222] *United States v. Braeview Manor, Inc.*, 87 AFTR2d paragraph 2001- 813 (N.D. Ohio Mar. 26, 2001).

[223] 148 B.R. 361 (Bankr. S.D. Ga. 1992).

[224] *See Remke, Inc.*, 5 B.R. 299 (Bankr. B.C. Mich. 1980).

[225] 1994 Bankr. LEXIS 1252 (Bankr. N.D. Ill. 1994).

out of the same transaction or occurrence out of which its claim arose. The court agreed with the trustee's contention that the claims arose from the same transaction because a logical relationship existed between the claims, reasoning that the antecedent debts giving rise to the preference claims were the unpaid portion of the taxes serving as the basis for the United States' claims against the state.

The Sixth Circuit Bankruptcy Appellate Panel affirmed the dismissal of a bankruptcy trustee's adversary proceeding filed against the Georgia Department of Revenue, holding that the state did not waive sovereign immunity by filing an unrelated proof of claim in the underlying bankruptcy proceeding.[226]

I.R.C. section 6503 suspends the running of the statute of limitations during the period when the taxpayer is in bankruptcy. However, the provision suspending the statute of limitations applies only to I.R.C. sections 6501 and 6502, and not to I.R.C. section 6229(f), which governs bankrupt partners under the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA). Thus, the limitations period may expire before the IRS is aware that a partner has gone bankrupt.

(n) Offers in Compromise

The IRS may accept an offer from the taxpayer when the IRS determines that the tax liability will most likely not be collected. The federal or state tax authority's objective in compromising the tax is to collect as much of the potential liability as is feasible—as soon as possible and at the least cost.

Bean[227] suggests that an offer in compromise may be used when the debtor is insolvent and does not have the cash flow to pay the debt over a reasonable period of time, and when an individual has just emerged from liquidation under chapter 7 or chapter 11. Bean indicates that the taxpayer should not use the offer in compromise if it is a calculated stall tactic or if the taxpayer is contemplating bankruptcy and the taxes are dischargeable.[228]

For federal income tax purposes, the taxpayer should use Form 656 (see section 10.6) to make the offer. On this form, the taxpayer must describe the tax liability, indicate the amount and terms of the offer, and describe the basis for the compromise.

Along with Form 656, an individual will complete Form 433-A; a business, including a sole proprietorship, partnership, or corporation, will complete Form 433-B. In addition to personal data, these forms require the taxpayer to provide information about bank accounts, bank credit cards or credit lines, and real and other property. Analyses of assets and liabilities and of income and expenses must be included.

The IRS may require that the compromise remain effective, with the taxpayer keeping current for any installment payments, for 5 years, to allow the IRS to keep prior and current refunds including benefits from prior years' net oper-

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[226] *In re ABEPP Acquisition Corp.*, 215 B.R. 513 (B.A.P. 6th Cir. 1997).
[227] Bean, Offer in Compromise, *Proc., 9th Annual Reorganization & Bankruptcy Conf.* 1 (1993).
[228] *Id.*

ating losses. The initial agreement may provide that, if the taxpayer defaults on the terms of the agreement, the entire amount of the tax liability will be due, less any payments made under the agreement to that date.

It may be difficult to estimate the minimum bid that the IRS will accept. Bean suggests that the IRS, in determining the amount that may be acceptable, may look at the net equity in assets plus the present value of future installments the taxpayer could make.[229]

The IRS has made special efforts to streamline the offer-in-compromise review process. The collection staff of the IRS informs the taxpayer of the availability of the offer in compromise and helps in preparing the necessary paperwork.

In describing the offer-in-compromise process, Kirchheimer[230] indicates that once an offer in compromise is submitted, it is assigned to a revenue officer or tax examiner for an investigation that will usually require 6 to 12 months. The investigation will involve a review of the taxpayer's financial statements (Form 433-A or Form 433-B) to determine their accuracy. The offer in compromise will be evaluated to see that it fits within the IRS guidelines. Typically, the collection division will check various records, including motor vehicle records and records at the county office of the taxpayer's residence and neighboring counties, to find unreported assets.[231] Additional investigations that are considered necessary by the collection department will be made, to determine that the taxpayer has made a full disclosure of assets and their future earnings potential.

The acceptance rates have varied significantly from district to district. David Keating, of the National Taxpayers Union in Washington, obtained data on the acceptance rate for offers in compromise in the various IRS districts. The 1993 acceptance rate ranged from a high of 79 percent in Mississippi to a low of 19 percent in the Laguna Niguel district of California.[232] In 1992, although the national acceptance rate was 45 percent, the rate among the IRS districts varied from 3 to 79 percent.[233] These variances seem great even for numbers having 63 sets of inputs.

Johnell Hunter, IRS public affairs spokesperson, has stated that there is no disparity in the way the IRS administers the tax laws across the country:

> An offer in compromise is accepted based on the type of assets a taxpayer has and on how much tax is owed . . . in areas where the acceptance rate is low . . . taxpayers did not offer enough money. If they had offered enough, we would have said yes. Our policy is nationwide. There should not be a disparity in interpreting the Internal Revenue Manual from one place to another.[234]

[229] *Id*. at 2.
[230] 62 Tax Notes 257 (1994).
[231] *Id*.
[232] *See* 62 Tax Notes 257 for tables showing acceptance for all districts for 1992 and 1993.
[233] *Id*., Table 2.
[234] As quoted in 62 *Tax Notes* 257, at 265.

The IRS has revised the Appeals Manual to include contingent agreement language to add to Form 870 for offers in compromise, as well as new instructions on case handling when bankrupt taxpayers object to the government's proof of claim or request that the bankruptcy court determine a tax liability. For additional information, see Manual Transmittal 8-241 (12-05-94).

The bankruptcy court held that the IRS may reopen and revoke its acceptance of a couple's offer in compromise if false information was submitted by one of the spouses, regardless of the couple's intent and regardless of whether the IRS relied on either spouse's representations.[235]

The bankruptcy court ruled that a tax debt was dischargeable under the 240-day rule of section 507(a)(8)(A)(ii) of the Bankruptcy Code. The court rejected the Service's argument that an offer in compromise was still pending after the agency told the taxpayer that he would have to submit a new offer.

The IRS sent a letter advising the taxpayer that the author had consulted IRS attorneys, who originally rejected the offer and indicated that three things need to occur before the offer could be accepted, including resubmission of the offer on a revised form, amendment to clarify that the amount deposited would be paid within a time certain after acceptance, and submission of additional substantiation of taxpayer's financial circumstances.

The court ruled that the February 1995 IRS letter terminated the offer. A letter from the IRS taking a position legally inconsistent with the notion of a pending offer should be construed as terminating the pendency of the offer.[236]

The bankruptcy court refused to allow the IRS to reopen an offer in compromise on the ground that the debtor had concealed assets from the IRS.[237] Citing *Jones v. United States*,[238] the bankruptcy court stated that falsification and concealment under the regulation means more than incorrect but less than fraud and requires a deliberate act or omission. It was the court's conclusion that the taxpayer may have legitimately believed at the time he made the offer in compromise that the trust was not available to him, because of the prior levy on the trust.

In calculating the equity in assets, the taxpayer should use liquidation values that could be obtained in a quick sale of assets over a relatively short period of time. The proceeds available should be reduced by any taxes that must be paid on the disposition, plus all cost to sell the assets. The property listed in I.R.C. section 6634 that is exempted from levy should be excluded from the equity in assets.

Generally, future income will be considered in determining the amount of the settlement. An individual will normally be allowed to deduct necessary living expenses, at a comfortable level, from the income.

In addition to the federal government, states may consider an offer in compromise. Often, these programs are similar to the IRS's agreement; however, the

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[235] *In re Jones*, 196 B.R. 542 (Bankr. D. Idaho 1996).
[236] *In re Hobbs*, 1996 Bankr. LEXIS 698 (Bankr. N.D. Iowa 1996).
[237] *In re Motter*, 1997 Bankr. LEXIS 304, 79 A.F.T.R.2d (P-H) 1676 (Bankr. M.D. Fla. 1997).
[238] 196 B.R. 542 (Bankr. D. Idaho 1996).

process is relatively new for many states and it may be much more difficult to reach an agreement with a state.

In a heavily redacted legal memorandum,[239] Kathryn A. Zuba, chief, branch 2 (collection, bankruptcy, and summonses), has concluded that once an offer-in-compromise has been terminated, it cannot be reinstated by the Service.

(o) Impact of Settlement

Once an agreement is finalized between the taxpayer and the IRS, it is considered a final judgment. In *In re West Texas Marketing Corp.*,[240] the bankruptcy court dismissed an adversary proceeding brought by the government to recover an excess amount that was refunded under the settlement agreement. The court ruled that the prior settlement had conclusively determined the refund owed to the trustee and that the court thus lacked jurisdiction to consider the government's complaint. The district court affirmed.

On appeal, the government argued that the lower courts erred by concluding that the settlement represented a final judgment. The Fifth Circuit held that the bankruptcy court had correctly refused to hear the government's attempt to relitigate issues decided by the settlement agreement, but remanded for consideration of the applicability of rule 60(a) of the Federal Rules of Civil Procedure to correct any possible clerical errors. The Circuit Court rejected the government's argument that the settlement agreement did not constitute a final judgment for res judicata purposes because the agreement did not include a final amount due. Citing *Fiataruolo v. United States*,[241] the court concluded that the settlement agreement was a final judgment because it clearly provided the means by which the final amount owed could be calculated. The court noted that the government signed away its rights to litigate the case further by agreeing to dismiss the previous action with prejudice.

The Fifth Circuit noted that Rule 60(a) of the Federal Rules of Civil Procedure, which provides that clerical mistakes and errors in a judgment arising from oversight or omission may be corrected by a court at any time, might provide the government relief with respect to any miscalculations.

In *Alexander v. United States*,[242] the Fifth Circuit held that a tax may not be assessed if it is not assessable, even though a compromise was reached on the tax liability in question. According to the IRS, Thomas Alexander's signature on the Form 870-P would constitute an offer to enter into a binding settlement to accept the adjustments. The Form 870-P stated that an executed settlement would be binding absent proof of fraud, malfeasance, or misrepresentation, and that no claim or refund based on the partnership items would be allowable. The IRS accepted the offer and made an assessment. It was subsequently determined that the tax was not assessable.

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[239] ILM 200113031; LTRServ, Apr. 9, 2001, p. 1782

[240] 12 F.3d 497 (5th Cir. 1994).

[241] 8 F.3d 930 (2d Cir. 1993).

[242] 44 F.3d 328 (5th Cir. 1995).

The Fifth Circuit ruled that the terms of the settlement agreement did not preclude Alexander's refund claim. The court reasoned that the settlement agreement merely precluded any claim for refund based on any change in the treatment of partnership items. The Fifth Circuit concluded that the adjustments to the partnership items were firm and binding, but that assessment of a deficiency based on those adjustments was time-barred. The Circuit Court found support in *Ewing v. United States.*[243]

In *Ewing*, the plaintiff-taxpayer mistakenly paid a time-barred deficiency after entering into a section 7121 closing agreement with the IRS. The court construed this amount as an "overpayment" under section 6401, which the IRS was ordered to refund. The Fourth Circuit concluded that the closing agreement, though valid and enforceable, did not preclude this particular action; instead, it simply agreed to the amount of income, gains, losses, deductions, and credits attributable to various businesses in which taxpayers were partners. The Fourth Circuit also noted that the taxpayers did not agree that they would abstain from claiming any refund that might be available to them under I.R.C. section 6401.

The Fifth Circuit in *Alexander* pointed out that the key distinction between *Ewing* and this case is the provision in Form 870-P prohibiting any claim for refund based on any change in the treatment of partnership items. The IRS argued that *Ewing* is distinguishable because *Alexander* specifically agreed not to prosecute any claim for refund or credit. This interpretation of the settlement agreement, according to the Fifth Circuit, disregards the restrictive, qualifying language emphasized above and the IRS has simply failed to establish how *Alexander's* refund claim is in any way based on a change in the treatment of partnership items.

In a 1992 field service advice,[244] the IRS advised that the acceptance of an offer in compromise does not result in discharge of indebtedness income. In analyzing the issue, the IRS first looked to I.R.C. section 7122 and the related regulations. I.R.C. section 7122 allows the IRS to compromise, among other items, a taxpayer's tax liability. Furthermore, Treas. Reg. section 301.7122-1(a) provides that "a compromise relates to the entire liability of the taxpayer (including taxes, ad valorem penalties, and interest) with respect to which the offer in compromise is submitted and all questions of such liability are conclusively settled thereby." The IRS found further support for its position in Office Memorandum 19866,[245] which concludes that a taxpayer does not have discharge of indebtedness income when the statute of limitations on the collection of a tax debt expires, or when an offer in compromise of tax debt is accepted by the IRS. The analysis in Office Memorandum 1986 cited *Eagle Asbestos & Packing Co. v. United States.*[246] In *Eagle Asbestos*, the court determined whether a taxpayer had income in a case in which a compromised tax debt included interest that the taxpayer had deducted. Because the intent of the parties was to extinguish all tax liabili-

[243] 914 F.2d 499 (4th Cir. 1990), *cert. denied*, 500 U.S. 905 (1991).
[244] FSA 1998-297, 98 TNT 197-93 (Oct. 13, 1998).
[245] I-201-84 (Nov. 26, 1984).
[246] 348 F.2d 528 (Ct. Cl. 1965).

ties for all items that made up the offer in compromise, the court held that the taxpayer did not have income.

Based on these authorities, the IRS concluded that a taxpayer does not realize income from the discharge of a tax liability pursuant to an offer in compromise even though the taxpayer may have economic gain.

§ 10.4 BANKRUPTCY COURTS

(a) Jurisdiction

Section 505 of the Bankruptcy Code authorizes the bankruptcy court to determine the tax liability of a debtor, provided the tax issue had not been contested and adjudicated before the commencement of the bankruptcy case. The bankruptcy court in *In re Mary Frances Richcreek*[247] refused to redetermine the tax that had been previously contested and adjudicated by the Tax Court. If Tax Court proceedings are pending at the time the bankruptcy petition is filed, the debtor and trustee have several options. If the debtor wishes to continue the Tax Court case, and the trustee agrees to intervene, the bankruptcy judge will lift the automatic stay on the proceedings under Bankruptcy Code section 362(a)(8), and the Tax Court's decision will bind both the debtor and the estate.[248] Under conditions where the trustee prefers to contest the tax claim in the bankruptcy court and the debtor agrees to have his personal liability also decided in the bankruptcy court, the issues regarding the tax claims against the estate and the debtor will be determined by the bankruptcy court.

The automatic stay does not operate in the case of an appeal of a Tax Court decision that was made before the petition was filed.

Section 362(a)(8) of the Bankruptcy Code states that the filing of a bankruptcy petition operates as a stay against the commencement or continuation of a proceeding before the U.S. Tax Court; however, the Ninth Circuit concluded that section 362(a)(8) has no application to appeals following the termination of proceedings in the Tax Court.[249]

Once a plan has been confirmed and the debtor has started making payments under the plan, it is difficult for the bankruptcy court to reopen the case to hear tax issues that were not resolved.

In *William Thomas Plachter, Jr. v. United States,*[250] the bankruptcy court dismissed a proceeding that requested the bankruptcy court to discharge the Plachters' 1971 through 1973 tax liabilities for which a proof of claim was not filed for lack of jurisdiction. The court noted that the Plachters' plan had been substantially consummated and, therefore, the court's post-confirmation jurisdiction had expired. The holding of the bankruptcy court was upheld by the district court.

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[247] No. IP-86-2978WP-V; LEXIS, 87 TNT 230-14 (Bankr. S.D. Ind. 1987).

[248] Singer, Determination of Tax Liability, p. 10 (mimeograph).

[249] *William P. Cheng v. Commissioner*, 938 F.2d 141 (9th Cir. 1991).

[250] 1992 U.S. Dist. LEXIS 17234 (S.D. Fla. 1992).

The district court also held that, even though the government had not filed a proof of claim for the 1971 through 1973 tax liabilities in the bankruptcy case, it was not estopped from asserting the deficiencies.

In *Richard A. Anderson v. United States,*[251] a Ninth Circuit bankruptcy appellate panel held that the bankruptcy court had jurisdiction to hear a case that involved the extent to which a tax lien attached to a pension benefit that was not part of the estate. The panel noted that the bankruptcy court had jurisdiction because the plan continued to remain the property of the debtor. In this case, Richard Anderson had a vested interest of $85,000 in a pension plan and the IRS had filed two tax liens prior to the petition, but had not levied against Anderson's interest in the pension plan.

If the debtor and trustee cannot agree on which forum should decide the case, the final decision is left to the bankruptcy judge. Singer suggests:

> [The judge] can refuse to lift the stay on the Tax Court proceeding. In that case, the trustee would be allowed to litigate the tax claim in the bankruptcy court and the Internal Revenue Service could require the debtor to litigate his personal liability there by filing a complaint to determine dischargeability. If the IRS does not file such a complaint, the stay against the Tax Court proceedings would be lifted after the bankruptcy case closes and the debtor could relitigate the issues in the Tax Court.
>
> [The judge also] can allow the debtor to litigate his personal liability in the Tax Court concurrently with the trustee's litigation of the same claim in the bankruptcy court. According to the conferee's explanation, the decision of the first court to rule on the tax claim would be conclusive on the other court.[252]

The above procedures apply to individual debtors. It is not clear whether corporate debtors have the same rights as individuals to litigate in the Tax Court.

If the bankruptcy court lifts the automatic stay, the debtor would not be precluded from filing a petition (if timely) in the Tax Court to challenge an asserted tax deficiency.[253]

I.R.C. section 6871(a) provides that, upon the appointment of a receiver for the taxpayer in any receivership, the tax may be assessed, and claims for a deficiency are to be presented to the court before which the receivership is pending. No petition for any redetermination of the tax can be filed with the Tax Court after the receiver is appointed. The Tax Court held in *Dennis B. Levine*[254] that it is the appointment of a receiver that invokes the prohibition of the filing of the petition with the Tax Court, even though some—but not all—of the assets are under the control of the court.

The Tenth Circuit held that a Tax Court ruling against the couple while the husband was in bankruptcy stands.[255] The wife argued that an earlier Tax Court

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[251] 149 Bankr. 591 (Bankr. 9th Cir. 1992).
[252] *Supra* note 248.
[253] S. Rep. No. 1035, 96th Cong., 2d Sess. 49 (1980).
[254] 54 T.C.M. (CCH) 1064 (1987).
[255] *Beery v. Commissioner*, 1998 U.S. App. LEXIS 31081; 99-1 U.S. Tax Cas. (CCH) P50,207; 82 A.F.T.R.2d (RIA) 7323 (10th Cir. 1998).

decision was not final because of her husband's subsequent bankruptcy and, as a result, this could not be the basis for the later summary judgment against her. The appeal court rejected her argument and in an unpublished opinion allowed the ruling to stand against the wife even though the Tax Court had dismissed the action against her husband because he was in bankruptcy.

(b) Awarding Attorneys' Fees

The Ninth Circuit held that bankruptcy courts are courts of the United States within the meaning of I.R.C. section 7430 and, thus, have jurisdiction to award attorney's fees.[256] The Ninth Circuit rejected the Eleventh Circuit's reasoning in *In re Brickell Investment Corp.*,[257] and concluded that the Fourth Circuit's decision in *In re Grewe*[258] is a more reasonable interpretation. Section 7430(c)(6), according to the Ninth Circuit, allows for attorney's fees in any civil action brought in a court of the United States (including the Tax Court and the U.S. Claims Court). The Ninth Circuit interpreted the language very broadly, while the Eleventh Circuit read it narrowly and concluded that, based on the special reference to the Tax Court and Claims Court, Congress would have mentioned bankruptcy courts if it had wanted to include them. Both the Ninth and the Fourth Circuit found that Congress intended the statute to apply broadly to civil tax litigation in all federal courts.

While the Ninth Circuit held that the bankruptcy court had jurisdiction to award attorney's fees, it denied the Yochums' motion for attorney's fees, on the basis that the government's position was substantially justified.

(c) Sole Agency Rule

Treas. Reg. section 1.1502-77(a) requires the parent corporation to act as the agent of its subsidiaries in all procedural matters in situations where consolidated returns were filed.

In *J&S Carburetor Co. v. Commissioner*,[259] deficiencies were assessed against the parent corporation and its subsidiary for years in which consolidated returns were filed. Prior to the issuance of the deficiency notice, the parent corporation had filed a bankruptcy petition. The automatic stay provision of the Bankruptcy Code precluded the parent from commencing litigation in the Tax Court. Thus, the subsidiaries that had not filed bankruptcy petitions tried to contest the deficiencies in the Tax Court.

The IRS claimed that the subsidiaries were precluded from filing a petition with the Tax Court under the sole agency rule of Treas. Reg. section 1.1502-77(a). The subsidiaries argued that they should not be deprived of the opportunity to file a petition contesting the claims of the IRS because the parent corporation filed a bankruptcy petition. The subsidiaries also argued that this situation is an

[256] *In re Yochum*, 89 F.3d 661 (9th Cir. 1996).
[257] 922 F.2d 696 (11th Cir. 1991).
[258] 4 F.3d 299 (4th Cir. 1993).
[259] 932 T.C. 166 (1989).

analogy to the situation where a spouse is entitled to file a petition to contest deficiencies on a joint return where the other spouse has filed bankruptcy.

The Tax Court held that an exception to the agency rule did not exist and it did not have the power to create one. Because the parent corporation had exclusive authority to file the petition to contest the deficiencies, the Tax Court held that it lacked jurisdiction over the petition filed by the subsidiaries. The court concluded that the taxpayer's vast understatement of income for 1977, combined with other evidence, showed a clear pattern of deceit.

(d) Tax Avoidance

A case may be dismissed if the bankruptcy plan is used to avoid tax liability.[260] Dean S. Hazel, a tax protester, filed for bankruptcy under chapter 13. The IRS objected to confirmation of the taxpayer's plan on the basis that it had not been proposed in good faith as required by section 1325(a)(3) of the Bankruptcy Code.

The District Court affirmed the bankruptcy court's denial of Hazel's petition on the basis that Hazel's plan "abuses both the spirit and purpose of chapter 13" by permitting the taxpayer to use the plan to obtain "a discharge of Federal tax liabilities which he never intended to pay."

§ 10.5 MINIMIZATION OF TAX AND RELATED PAYMENTS

There are several steps that a debtor in financial difficulty might take to reduce the cash outflow for taxes or to obtain tax refunds.

(a) Estimated Taxes

A company having financial problems may, after paying one or more installments of estimated taxes, determine that it should recompute its estimated tax liability. Downward recomputations may show that no additional payments are necessary. If it is determined that too much tax was paid, a quick refund can be obtained by filing Form 4466 immediately after the taxable year ends.

(b) Prior Year Taxes

The IRS allows companies that owe taxes from the previous year to extend the time for payment to the extent that the tax will be reduced because of an expected net operating loss in the current year. This request is made on Form 1138. To obtain a quick refund of taxes previously paid, Form 1139 must be filed within one year after the end of the year in which the net operating loss occurred and can be filed only after Form 1120 for the loss year has been filed.

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[260] *Hazel v. Commissioner*, 696 F.2d 473 (6th Cir. 1989).

(c) Pension Funding Requirements

An employer may be able to obtain a funding waiver if it can show that substantial business hardship exists and that funding the pension would be adverse to the interests of the plan's participants in the aggregate. If the funding cannot be waived, payments may be deferred under Rev. Rul. 66-144.[261]

[261] 1966-1 C.B. 91; *see* Rev. Rul. 84-18, 1984-1 C.B. 88.

§ 10.6 APPENDIX: FORMS

Form 56—Notice Concerning Fiduciary Relationship

Form **56**
(Rev. July 2004)
Department of the Treasury
Internal Revenue Service

Notice Concerning Fiduciary Relationship

(Internal Revenue Code sections 6036 and 6903)

OMB No. 1545-0013

Part I Identification

Name of person for whom you are acting (as shown on the tax return)	Identifying number	Decedent's social security no.
Address of person for whom you are acting (number, street, and room or suite no.)		
City or town, state, and ZIP code (If a foreign address, see instructions.)		
Fiduciary's name		
Address of fiduciary (number, street, and room or suite no.)		
City or town, state, and ZIP code	Telephone number (optional) ( )	

Part II Authority

1 Authority for fiduciary relationship. Check applicable box:
a(1) ☐ Will and codicils or court order appointing fiduciary . . . . (2) Date of death ....
b(1) ☐ Court order appointing fiduciary . . . . (2) Date (see instructions) ....
c ☐ Valid trust instrument and amendments
d ☐ Other. Describe ▶ ....

Part III Nature of Liability and Tax Notices

2 Type of tax (estate, gift, generation-skipping transfer, income, excise, etc.) ▶ ....
3 Federal tax form number (706, 1040, 1041, 1120, etc.) ▶ ....
4 Year(s) or period(s) (if estate tax, date of death) ▶ ....
5 If the fiduciary listed in Part I is the person to whom notices and other written communications should be sent for **all** items described on lines 2, 3, and 4, check here . . . . ▶ ☐
6 If the fiduciary listed in Part I is the person to whom notices and other written communications should be sent for **some** (but not all) of the items described on lines 2, 3, and 4, check here ▶ ☐ and list the applicable Federal tax form number and the year(s) or period(s) applicable ....

Part IV Revocation or Termination of Notice

Section A—Total Revocation or Termination

7 Check this box if you are revoking or terminating all prior notices concerning fiduciary relationships on file with the Internal Revenue Service for the same tax matters and years or periods covered by this notice concerning fiduciary relationship . ▶ ☐
Reason for termination of fiduciary relationship. Check applicable box:
a ☐ Court order revoking fiduciary authority
b ☐ Certificate of dissolution or termination of a business entity
c ☐ Other. Describe ▶

Section B—Partial Revocation

8a Check this box if you are revoking earlier notices concerning fiduciary relationships on file with the Internal Revenue Service for the same tax matters and years or periods covered by this notice concerning fiduciary relationship . . . . ▶ ☐
b Specify to whom granted, date, and address, including ZIP code.
▶ ....

Section C—Substitute Fiduciary

9 Check this box if a new fiduciary or fiduciaries have been or will be substituted for the revoking or terminating fiduciary and specify the name(s) and address(es), including ZIP code(s), of the new fiduciary(ies) . . . . ▶ ☐
▶ ....

For Paperwork Reduction Act and Privacy Act Notice, see back page. Cat. No. 16375I Form **56** (Rev. 7-2004)

Form 56—Notice Concerning Fiduciary Relationship *(continued)*

Form 56 (Rev. 7-2004) Page 2

Part V **Court and Administrative Proceedings**

Name of court (if other than a court proceeding, identify the type of proceeding and name of agency)			Date proceeding initiated
Address of court			Docket number of proceeding
City or town, state, and ZIP code	Date	Time a.m. p.m.	Place of other proceedings

Part VI **Signature**

Please Sign Here

I certify that I have the authority to execute this notice concerning fiduciary relationship on behalf of the taxpayer.

Fiduciary's signature	Title, if applicable	Date

Form **56** (Rev. 7-2004)

Form 656—Offer in Compromise

Department of the Treasury
Internal Revenue Service
www.irs.gov
Form 656 (Rev. 5-2001)
Catalog Number 16728N

Form 656

Offer in Compromise

IRS RECEIVED DATE

Item 1 — Taxpayer's Name and Home or Business Address

Name ______

Name ______

Street Address ______

City ______ State ______ ZIP Code ______

Mailing Address *(if different from above)*

Street Address ______

City ______ State ______ ZIP Code ______

DATE RETURNED

Item 2 — Social Security Numbers

(a) Primary ______

(b) Secondary ______

Item 3 — Employer Identification Number *(included in offer)*

______

Item 4 — Other Employer Identification Numbers *(not included in offer)* ______

______

______

Item 5 — To: Commissioner of Internal Revenue Service

I/We (includes all types of taxpayers) submit this offer to compromise the tax liabilities plus any interest, penalties, additions to tax, and additional amounts required by law (tax liability) for the tax type and period marked below: (Please mark an "X" in the box for the correct description and fill-in the correct tax period(s), adding additional periods if needed).

☐ **1040/1120 Income Tax** — Year(s) ______

☐ **941 Employer's Quarterly Federal Tax Return** — Quarterly period(s) ______

☐ **940 Employer's Annual Federal Unemployment (FUTA) Tax Return** — Year(s) ______

☐ **Trust Fund Recovery Penalty** as a responsible person of (enter corporation name) ______

______ for failure to pay withholding and Federal Insurance Contributions Act Taxes (Social Security taxes), for period(s) ending ______.

☐ **Other Federal Tax(es)** [specify type(s) and period(s)] ______

***Note:** If you need more space, use another sheet titled "Attachment to Form 656 Dated ______." Sign and date the attachment following the listing of the tax periods.*

Item 6 — I/We submit this offer for the reason(s) checked below:

☐ **Doubt as to Liability** — "I do not believe I owe this amount." You must include a detailed explanation of the reason(s) why you believe you do not owe the tax in Item 9.

☐ **Doubt as to Collectibility** — "I have insufficient assets and income to pay the full amount." You must include a complete Collection Information Statement, Form 433-A and/or Form 433-B.

☐ **Effective Tax Administration** — "I owe this amount and have sufficient assets to pay the full amount, but due to my exceptional circumstances, requiring full payment would cause an economic hardship or would be unfair and inequitable." You must include a complete Collection Information Statement, Form 433-A and/or Form 433B **and** complete Item 9.

Item 7

I/We offer to pay $ ______ (must be more than zero). Complete item 10 to explain where you will obtain the funds to make this offer.

Check one of the following:

☐ **Cash Offer (Offered amount will be paid in 90 days or less.)**

Balance to be paid in: ☐ 10; ☐ 30; ☐ 60; or ☐ 90 days from written notice of acceptance of the offer.

☐ **Short-Term Deferred Payment Offer (Offered amount will be paid in MORE than 90 days but within 24 months from written notice of acceptance of the offer.)**

$______ within ______ days (not more than 90 — See Instructions Section, **Determine Your Payment Terms**) from written notice of acceptance of the offer; and

beginning in the ______ month after written notice of acceptance of the offer, $______ on the ______ day of each month for a total of ______ months. (Cannot extend more than 24 months from written notice of acceptance of the offer.)

☐ **Deferred Payment Offer (Offered amount will be paid over the life of the collection statute.)**

$______ within ______ days (not more than 90 — See Instructions Section, **Determine Your Payment Terms**) from written notice of acceptance of the offer; and

beginning in the first month after written notice of acceptance of the offer, $______ on the ______ day of each month for a total of ______ months.

NOTE: Signature(s) of taxpayer required on last page of Form 656

Form 656—Offer in Compromise *(continued)*

Item 8 — By submitting this offer, I/we understand and agree to the following conditions:

(a) I/We voluntarily submit all payments made on this offer.

(b) The IRS will apply payments made under the terms of this offer in the best interest of the government.

(c) If the IRS rejects or returns the offer or I/we withdraw the offer, the IRS will return any amount paid with the offer. If I/we agree in writing, IRS will apply the amount paid with the offer to the amount owed. If I/we agree to apply the payment, the date the IRS received the offer remittance will be considered the date of payment. I/We understand that the IRS will not pay interest on any amount I/we submit with the offer.

(d) I/We will comply with all provisions of the Internal Revenue Code relating to filing my/our returns and paying my/our required taxes for 5 years or until the offered amount is paid in full, whichever is longer. In the case of a jointly submitted offer to compromise joint tax liabilities, I/we understand that default with respect to the compliance provisions described in this paragraph by one party to this agreement will not result in the default of the entire agreement. The default provisions described in Item 8(n) of this agreement will be applied only to the party failing to comply with the requirements of this paragraph. This provision does not apply to offers based on Doubt as to Liability.

(e) I/We waive and agree to the suspension of any statutory periods of limitation (time limits provided for by law) for the IRS assessment of the tax liability for the periods identified in Item 5. I/We understand that I/we have the right not to waive these statutory periods or to limit the waiver to a certain length or to certain issues. I/We understand, however, that the IRS may not consider this offer if I/we refuse to waive the statutory periods for assessment or if we provide only a limited waiver. The amount of any Federal tax due for the periods described in Item 5 may be assessed at any time prior to the acceptance of this offer or within one year of the rejection of this offer.

(f) The IRS will keep all payments and credits made, received or applied to the total original tax liability before submission of this offer. The IRS may keep any proceeds from a levy served prior to submission of the offer, but not received at the time the offer is submitted. If I/we have an installment agreement prior to submitting the offer, I/we must continue to make the payments as agreed while this offer is pending. Installment agreement payments will not be applied against the amount offered.

(g) As additional consideration beyond the amount of my/our offer, the IRS will keep any refund, including interest, due to me/us because of overpayment of any tax or other liability, for tax periods extending through the calendar year that the IRS accepts the offer. I/We may not designate an overpayment ordinarily subject to refund, to which the IRS is entitled, to be applied to estimated tax payments for the following year. This condition does not apply if the offer is based on Doubt as to Liability.

(h) I/We will return to the IRS any refund identified in (g) received after submission of this offer. This condition does not apply to offers based on Doubt as to Liability.

(i) The IRS cannot collect more than the full amount of the tax liability under this offer.

(j) I/We understand that I/we remain responsible for the full amount of the tax liability, unless and until the IRS accepts the offer in writing and I/we have met all the terms and conditions of the offer. The IRS will not remove the original amount of the tax liability from its records until I/we have met all the terms of the offer.

NOTE: Signature(s) of taxpayer required on last page of Form 656

(continues)

Form 656—Offer in Compromise *(continued)*

(k) I/We understand that the tax I/we offer to compromise is and will remain a tax liability until I/we meet all the terms and conditions of this offer. If I/we file bankruptcy before the terms and conditions of this offer are completed, any claim the IRS files in the bankruptcy proceedings will be a tax claim.

(l) Once the IRS accepts the offer in writing, I/we have no right to contest, in court or otherwise, the amount of the tax liability.

(m) The offer is pending starting with the date an authorized IRS official signs this form. The offer remains pending until an authorized IRS official accepts, rejects, returns or acknowledges withdrawal of the offer in writing. If I/we appeal an IRS rejection decision on the offer, the IRS will continue to treat the offer as pending until the Appeals Office accepts or rejects the offer in writing. If I/we don't file a protest within 30 days of the date the IRS notifies me/us of the right to protest the decision, I/we waive the right to a hearing before the Appeals Office about the offer in compromise.

(n) If I/We fail to meet any of the terms and conditions of the offer and the offer defaults, then the IRS may:

- immediately file suit to collect the entire unpaid balance of the offer
- immediately file suit to collect an amount equal to the original amount of the tax liability as liquidating damages, minus any payment already received under the terms of this offer
- disregard the amount of the offer and apply all amounts already paid under the offer against the original amount of the tax liability
- file suit or levy to collect the original amount of the tax liability, without further notice of any kind.

The IRS will continue to add interest, as Section 6601 of the Internal Revenue Code requires, on the amount the IRS determines is due after default. The IRS will add interest from the date the offer is defaulted until I/we completely satisfy the amount owed.

(o) The IRS generally files a Notice of Federal Tax Lien to protect the Government's interest on deferred payment offers. This tax lien will be released when the payment terms of the offer agreement have been satisfied.

(p) I/We understand that the IRS employees may contact third parties in order to respond to this request and I authorize the IRS to make such contacts. Further, by authorizing the Internal Revenue Service to contact third parties, I understand that I will not receive notice, pursuant to section 7602(c) of the Internal Revenue Code, of third parties contacted in connection with this request.

NOTE: Signature(s) of taxpayer required on last page of Form 656

Form 656—Offer in Compromise *(continued)*

Item 9 — **Explanation of Circumstances**

I am requesting an offer in compromise for the reason(s) listed below:

Note: ***If you are requesting compromise based on doubt as to liability, explain why you don't believe you owe the tax. If you believe you have special circumstances affecting your ability to fully pay the amount due, explain your situation. You may attach additional sheets if necessary.***

Item 10 — **Source of Funds**

I/we shall obtain the funds to make this offer from the following source(s):

Item 11

If I/we submit this offer on a substitute form, I/we affirm that this form is a verbatim duplicate of the official Form 656, and I/we agree to be bound by all the terms and conditions set forth in the official Form 656.

Under penalties of perjury, I declare that I have examined this offer, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct and complete.

11(a) Signature of Taxpayer

Date

11(b) Signature of Taxpayer

Date

For Official Use Only

I accept the waiver of the statutory period of limitations for the Internal Revenue Service.

Signature of Authorized Internal Revenue Service Official

Title

Date

NOTE: Signature(s) of taxpayer required on last page of Form 656

Form 433-B—Collection Information Statement for Businesses

Collection Information Statement for Businesses

Department of the Treasury
Internal Revenue Service
www.irs.gov
Form 433-B (Rev. 5-2001)
Catalog Number 16649P

Complete all entry spaces with the most current data available.
Important! Write "N/A" (not applicable) in spaces that do not apply. We may require additional information to support "N/A" entries.
Failure to complete all entry spaces may result in rejection or significant delay in the resolution of your account.

Section 1 Business Information

1a. Business Name
Business Street Address
City State Zip
County
1b. Business Telephone ( )
2a. Employer Identification No. (EIN)
2b. Type of Entity (Check appropriate box below)
☐ Partnership ☐ Corporation ☐ Other
2c. Type of Business

3a. Contact Name
3b. Contact's Business Telephone ( )
Extension
Best Time To Call am pm (Enter Hour)
3c. Contact's Home Telephone ( )
Best Time To Call am pm (Enter Hour)
3d. Contact's Other Telephone ( )
Telephone Type (i.e. fax, cellular, pager)
3e. Contact's E-mail Address

☐ Check this box when all spaces in Sect. 1 are filled in.

Section 2 Business Personnel and Contacts

4. **PERSON RESPONSIBLE FOR DEPOSITING PAYROLL TAXES**

4a. Full Name Title
Home Street Address
City State Zip
Social Security Number
Home Telephone ( )
Ownership Percentage & Shares or Interest

5. **PARTNERS, OFFICERS, MAJOR SHAREHOLDERS, ETC.**

5a. Full Name Title
Home Street Address
City State Zip
Social Security Number
Home Telephone ( )
Ownership Percentage & Shares or Interest

5b. Full Name Title
Home Street Address
City State Zip
Social Security Number
Home Telephone ( )
Ownership Percentage & Shares or Interest

5c. Full Name Title
Home Street Address
City State Zip
Social Security Number
Home Telephone ( )
Ownership Percentage & Shares or Interest

5d. Full Name Title
Home Street Address
City State Zip
Social Security Number
Home Telephone ( )
Ownership Percentage & Shares or Interest

☐ Check this box when all spaces in Sect. 2 are filled in.

Section 3 Accounts/Notes Receivable

See page 6 for additional space, if needed.

6. **ACCOUNTS/NOTES RECEIVABLE.** List all contracts separately, including contracts awarded, but not started.

	Description	Amount Due	Date Due	Age of Account
6a.	Name Street Address City/State/Zip	$		☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6b.	Name Street Address City/State/Zip	$		☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days

6a + 6b = 6c — 6c $
Amount from Page 6 + — 6p
6q. Total Accounts/Notes Receivable = — 6c + 6p = 6q $

☐ Check this box when all spaces in Sect. 3 are filled in.

Page 1 of 8

Section 4 begins on page 2 →

(Rev. 5-2001)

Form 433-B—Collection Information Statement for Businesses *(continued)*

Collection Information Statement for Businesses **Form 433-B**

Business Name ______________________ **EIN** ______________________

Section 4 Other Financial Information

7. OTHER FINANCIAL INFORMATION. Respond to the following business financial questions.

7a. Does this business have other business relationships (e.g. subsidiary or parent, corporation, partnership, etc.)? ☐ No ☐ Yes
If yes, list related EIN ______________ Additional EIN ______________

7b. Does anyone (e.g. officer, stockholder, partner or employees) have an outstanding loan borrowed from the business? ☐ No ☐ Yes
If yes, amount of loan $ ________ Date of loan ________ Current balance $________

7c. Are there any judgments or liens against your business? ☐ No ☐ Yes
If yes, who is the creditor? ________ Date creditor obtained judgment/lien ________ Amount of debt $ ________

7d. Is your business a party in a lawsuit? ☐ No ☐ Yes
If yes, amount of suit $ ________ Possible completion date ________ Subject matter of suit ________

7e. Has your business ever filed bankruptcy? ☐ No ☐ Yes
If yes, date filed ________ Date discharged ________ Petition No. ________

7f. In the past 10 years have you transferred any assets from your business name for less than their actual value? ☐ No ☐ Yes
If yes, what asset? ________ Value of asset at time of transfer $________
When was it transferred? ________ To whom or where was it transferred? ________

7g. Do you anticipate any increase in business income (e.g. contracts bid but not yet awarded)? ☐ No ☐ Yes
If yes, why will the income increase? ________ (Attach sheet if you need additional space.)
How much will it increase? ________ When will the business income increase? ________

7h. Is your business a beneficiary of a trust, an estate or a life insurance policy? ☐ No ☐ Yes
If yes, name of the trust, estate or policy? ________ Anticipated amount to be received? ________
When will the amount be received? ________

☐ Check this box when all spaces in Sect. 4 are filled in.

Section 5 Business Assets

¤ **Current Value:** Indicate the amount you could sell the asset for today.

8. PURCHASED AUTOMOBILES, TRUCKS AND OTHER LICENSED ASSETS. Include boats, RV's, motorcycles, trailers, etc. (If you need additional space, attach a separate sheet.)

	Description (Year, Make, Model, Mileage)	¤ Current Value	Loan Balance	Name of Lender	Purchase Date	Amount of Monthly Payment
8a.	Year Make/Model Mileage	$	$			$
8b.	Year Make/Model Mileage	$	$			$
8c.	Year Make/Model Mileage	$	$			$

9. LEASED AUTOMOBILES, TRUCKS AND OTHER LICENSED ASSETS. Include boats, RV's, motorcycles, trailers, etc. (If you need additional space, attach a separate sheet.)

	Description (Year, Make, Model)	Lease Balance	Name of Lessor	Lease Date	Amount of Monthly Payment
9a.	Year Make/Model	$			$
9b.	Year Make/Model	$			$

ATTACHMENTS REQUIRED: Please include your current statement from lender with monthly car payment amount and current balance of the loan for each vehicle purchased or leased.

Page 2 of 6

Section 5 continued on page 3 →

(Rev. 5-2001)

Form 433-B—Collection Information Statement for Businesses *(continued)*

Collection Information Statement for Businesses **Form 433-B**

Business Name ______________________ **EIN** ____________

Section 5 continued

¤ **Current Value:** Indicate the amount you could sell the asset for today.

***Date of Final Payment:** Enter the date the loan or lease will be fully paid.

10. REAL ESTATE. List all real estate owned by the business. (If you need additional space, attach a separate sheet.)

	Street Address, City, State, Zip, and County	Date Purchased	Purchase Price	¤ Current Value	Loan Balance	Name of Lender or Lien Holder	Amount of Monthly Payment	*Date of Final Payment
10a.			$	$	$		$	
10b.			$	$	$		$	

ATTACHMENTS REQUIRED: Please include your current statement from lender with monthly payment amount and current balance for each piece of real estate owned.

☐ *Check this box if you are attaching a depreciation schedule for machinery/equipment in lieu of completing line 11.*

11. BUSINESS ASSETS. List all business assets and encumbrances below, include Uniform Commercial Code (UCC) filings. (If you need additional space, attach a separate sheet.) Note: If attaching a depreciation schedule, the attachment must include all of the information requested below.

	Description	¤ Current Value	Loan Balance	Name of Lender	Amount of Monthly Payment	*Date of Final Payment
11a.	Machinery	$	$		$	
	Equipment					
	Merchandise					
	Other Assets: (List below)					
11b.		$	$		$	
11c.						

☐ Check this box when all spaces in Sect. 5 are filled in and attachments provided.

ATTACHMENTS REQUIRED: Please include your current statement from lender with monthly payment amount and current loan balance for assets listed which have an encumbrance.

Section 6 Investment, Banking and Cash Information

12. INVESTMENTS. List all investment assets below. Include stocks, bonds, mutual funds, stock options and certificates of deposits.

	Name of Company	Number of Shares / Units	¤ Current Value	Loan Amount	Used as collateral on loan?
12a.			$	$	☐ No ☐ Yes
12b.					☐ No ☐ Yes

12c. Total Investments $ ________

Page 3 of 6

Section 6 continued on page 4 →

(Rev. 5-2001)

Form 433-B—Collection Information Statement for Businesses *(continued)*

Collection Information Statement for Businesses **Form 433-B**

Business Name ______________________ **EIN** ______________

Section 6 continued

Complete all entry spaces with the most current data available.

13. BANK ACCOUNTS. List all checking and savings accounts. (If you need additional space, attach a separate sheet.)

	Type of Account	Full Name of Bank, Savings & Loan, Credit Union or Financial Institution	Bank Routing No.	Bank Account No.	Current Account Balance
13a.	Checking	Name Street Address City/State/Zip			$
13b.	Checking	Name Street Address City/State/Zip			$
13c.	Savings	Name Street Address City/State/Zip			$
			13d. Total Bank Account Balances		$

ATTACHMENTS REQUIRED: Please include your current bank statements (checking and savings) for the past three months for all accounts.

14. OTHER ACCOUNTS. List all accounts including brokerage accounts, money market, additional checking and savings accounts not listed on line #13 and any other accounts not listed in this section.

	Type of Account	Full Name of Bank, Savings & Loan, Credit Union or Financial Institution	Bank Routing No.	Bank Account No.	Current Account Balance
14a.		Name Street Address City/State/Zip			$
14b.		Name Street Address City/State/Zip			$
			14c. Total Other Account Balances		$

ATTACHMENTS REQUIRED: Please include your current bank statements (checking, savings, money market, and brokerage accounts) for the past three months for all accounts.

15. CASH ON HAND. Include any money that you have that is not in the bank.

15a. Total Cash on Hand $

16. AVAILABLE CREDIT. List all lines of credit, including credit cards.

	Full Name of Credit Institution	Credit Limit	Amount Owed	Available Credit
16a.	Name Street Address City/State/Zip			$
16b.	Name Street Address City/State/Zip			$
			16c. Total Credit Available	$

☐ Check this box when all spaces in Sect. 6 are filled in and attachments provided.

Page 4 of 6

Section 7 begins on page 5 →

(Rev. 5-2001)

Form 433-B—Collection Information Statement for Businesses *(continued)*

Collection Information Statement for Businesses **Form 433-B**

Business Name ______________________ **EIN** ______________

Section 7 Monthly Income and Expenses

Complete all entry spaces with the most current data available.

17. The following information applies to income and expenses from your most recently filed Form 1120 or Form 1065.
Fiscal Year Period ________ to ________

18. Accounting Method Used: ☐ Cash ☐ Accrual

The information included on lines 19 through 39 should reconcile to your business federal tax return.

Total Income Source	Gross Monthly	***Total Expenses*** Expense Items	Actual Monthly
19. Gross Receipts	$	27. Materials Purchased [1]	$
20. Gross Rental Income		28. Inventory Purchased [2]	
21. Interest		29. Gross Wages & Salaries	
22. Dividends		30. Rent	
Other Income (specify in lines 23-25)		31. Supplies [3]	
23.		32. Utilities / Telephone [4]	
24.		33. Vehicle Gasoline / Oil	
25.		34. Repairs & Maintenance	
(Add lines 19 through 25)		35. Insurance	
26. **TOTAL INCOME**	$	36. Current Taxes [5]	
		Other Expenses (Include installment payments, specify in lines 37-38)	
		37.	
		38.	
		(Add lines 27 through 38)	
		39. **TOTAL EXPENSES**	$

[1] **Materials Purchased:** Materials are items directly related to the production of a product or service.

[2] **Inventory Purchased:** Goods bought for resale.

[3] **Supplies:** Supplies are items used in your business that are consumed or used up within one year, this could be the cost of books, office supplies, professional instruments, etc.

[4] **Utilities:** Utilities include gas, electricity, water, fuel, oil, other fuels, trash collection and telephone.

[5] **Current Taxes:** Real estate, state and local income tax, excise, franchise, occupational, personal property, sales and the employer's portion of employment taxes.

☐ Check this box when all spaces in Sect. 7 are filled in.

☐ Check this box when all spaces in all sections are filled in and all attachments provided.

Failure to complete all entry spaces may result in rejection or significant delay in the resolution of your account.

Certification: Under penalties of perjury, I declare that to the best of my knowledge and belief this statement of assets, liabilities, and other information is true, correct and complete.

Print Name ______________ Title ______________

Your Signature ______________ Date ______________

Page 5 of 6

Accounts/Notes Receivable Continuation on page 6 →

(Rev. 5-2001)

Form 433-B—Collection Information Statement for Businesses *(continued)*

Collection Information Statement for Businesses **Form 433-B**

Business Name ____________ **EIN** ____________

Section 3
Accounts/ Notes Receivable continued

Use only if needed.

☐ *Check this box if this page is not needed.*

ACCOUNTS/NOTES RECEIVABLE CONTINUATION PAGE. List all contracts separately, including contracts awarded, but not started. (If you need additional space, copy this page and attach to the 433-B package.)

	Description	Amount Due	Date Due	Age of Account
6d.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6e.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6f.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6g.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6h.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6i.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6j.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6k.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6l.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6m.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6n.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days
6o.	Name ____ Street Address ____ City/State/Zip ____	$____	____	☐ 0 - 30 days ☐ 30 - 60 days ☐ 60 - 90 days ☐ 90+ days

☐ Check this box when all spaces in Sect. 3 are filled

Add lines 6d through 6o = 6p $____ ***(Add this amount to amount on line 6c, Section 3, page 1)***

Page 6 of 6

(Rev. 5-2001)

Form 4466—Corporation Application for Quick Refund of Overpayment of Estimated Tax

Form **4466** (Rev. November 2003) Department of the Treasury Internal Revenue Service

Corporation Application for Quick Refund of Overpayment of Estimated Tax

OMB No. 1545-0170

For calendar year 20 or tax year beginning , 20 , and ending , 20

Name	**Employer identification number**
Number, street, and room or suite no. (If a P.O. box, see instructions.)	Telephone number (optional) ( )
City or town, state, and ZIP code	

Check type of return to be filed (see instructions):

☐ Form 1120 ☐ Form 1120-A ☐ Form 1120-F ☐ Form 1120-L ☐ Form 1120-PC ☐ Form 990-C ☐ Other ▶

Line	Description			Line	Amount
1	Estimated income tax paid during the tax year			1	
2	Overpayment of income tax from prior year credited to this year's estimated tax			2	
3	Total. Add lines **1** and 2			3	
4	Enter total tax from Form 1120, Schedule J, line 11, or comparable line from other returns	4			
5a	Personal holding company tax, if any, included on line **4**	5a			
b	Estimated refundable tax credit for Federal tax on fuels	5b			
6	Total. Add lines 5a and 5b	6			
7	Expected income tax liability for the tax year. Subtract line 6 from line 4			7	
8	**Overpayment of estimated tax.** Subtract line 7 from line 3. If this amount is at least 10% of line 7 **and** at least $500, the corporation is eligible for a quick refund. Otherwise, do not file this form (see instructions)			8	

Record of Estimated Tax Deposits

Date of deposit	Amount	Date of deposit	Amount

Sign Here

Under penalties of perjury, I declare that I have examined this application, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

▶ Signature | Date ▶ Title

Form 1138—Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback

Form **1138**
(Rev. February 1998)
Department of the Treasury
Internal Revenue Service

Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback

(Under Section 6164 of the Internal Revenue Code)

OMB No. 1545-0135

Name | **Employer identification number**

Number, street, and room or suite no. (If a P.O. box, see instructions.)

City or town, state, and ZIP code

1 Ending date of the tax year of the expected net operating loss (NOL)

2 Amount of expected NOL
$

3 Reduction of previously determined tax attributable to the expected NOL carryback. **Attach a schedule.** See instructions . . . . ▶ $

4 Ending date of the tax year immediately preceding the tax year of the expected NOL

5 Give the reasons, facts, and circumstances that cause the corporation to expect an NOL.

6 Amount for Which Payment Is To Be Extended:

a Enter the total tax shown on the return, plus any amount assessed as a deficiency, interest, or penalty. See instructions . . . . | 6a

b Enter amounts from line 6a that were already paid or were required to have been paid, plus refunds, credits, and abatements. See instructions . . . . | 6b

c Subtract line 6b from line 6a. Do not enter more than the amount on line 3 above. This is the amount of tax for which the time for payment is extended . . . . | 6c

Sign Here

Under penalties of perjury, I declare that I have examined this form, including any accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Keep a copy of this form for your records.

▶ Signature of officer ▶ Date ▶ Title

For Paperwork Reduction Act Notice, see instructions on back. Cat. No. 17250W Form **1138** (Rev. 2-98)

Form 1139—Corporation Application for Tentative Refund

Form **1139**
(Rev. June 2002)
Department of the Treasury
Internal Revenue Service

Corporation Application for Tentative Refund

▶ Read the separate instructions before completing this form.

▶ Do not attach to the corporation's income tax return—mail in a separate envelope.

OMB No. 1545-0582

Name	Employer identification number
Number, street, and room or suite no. (If a P.O. box, see instructions.)	Date of incorporation
City or town, state, and ZIP code	Daytime phone number ( )

1	This application is filed to carry back:	a Net operating loss (NOL) (attach computation) ▶	$	c Unused general business credit (attach computation) ▶	$
		b Net capital loss (attach computation) ▶	$		
2	Return for year of loss, unused credit, or overpayment under section 1341(b)(1) ▶	a Tax year ended	b Date tax return filed	c Service center where filed	

3 If this application is for an unused credit created by another carryback, enter ending date for the tax year of the first carryback ▶ ....

4 Did an NOL or net capital loss result in the release of a foreign tax credit, or is the corporation carrying back a general business credit that was released because of the release of a foreign tax credit (see instructions)? If "Yes," the corporation must file an amended return to carry back the released credits. ☐ Yes ☐ No

5a Was a consolidated return filed for any carryback year or did the corporation join a consolidated group (see instructions)? ☐ Yes ☐ No

b If "Yes," enter the tax year ending date and the name of the common parent and its EIN, if different from above (see instructions) ▶ ......

6a If Form 1138 has been filed, was an extension of time granted for filing the return for the tax year of the NOL? ☐ Yes ☐ No

b If "Yes," enter the date to which extension was granted ▶ .... c Enter the date Form 1138 was filed ▶ ....

d Unpaid tax for which Form 1138 is in effect ▶ ....

7 If the corporation changed its accounting period, enter the date permission to change was granted ▶ ....

8 If this is an application for a dissolved corporation, enter date of dissolution ▶ ....

9 Has the corporation filed a petition in Tax Court for the year or years to which the carryback is to be applied? ☐ Yes ☐ No

10 Does this application include a loss or credit from a tax shelter required to be registered? If "Yes," attach Form(s) 8271 ☐ Yes ☐ No

Computation of Decrease in Tax See page 2 of the instructions.	.... preceding tax year ended ▶		.... preceding tax year ended ▶		.... preceding tax year ended ▶	
Note: *If lines 1a and 1b are blank, skip lines 11 through 15.*	(a) Before carryback	(b) After carryback	(c) Before carryback	(d) After carryback	(e) Before carryback	(f) After carryback
11 Taxable income from tax return						
12 **Capital loss carryback (see instructions)**						
13 Subtract line 12 from line 11						
14 **NOL deduction (see instructions)**						
15 Taxable income. Subtract line 14 from line 13						
16 **Income tax**						
17 Alternative minimum tax						
18 Add lines 16 and 17						
19 General business credit (see instructions)						
20 Other credits (see instructions)						
21 Total credits. Add lines 19 and 20						
22 Subtract line 21 from line 18						
23 Personal holding company tax (Sch. PH (Form 1120))						
24 Other taxes (see instructions)						
25 Total tax liability. Add lines 22 through 24						
26 Enter amount from "After carryback" column on line 25 for each year						
27 Decrease in tax. Subtract line 26 from line 25						

28 Overpayment of tax due to a claim of right adjustment under section 1341(b)(1) (attach computation)

Sign Here Under penalties of perjury, I declare that I have examined this application and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Keep a copy of this application for your records. ▶ Signature of officer ▶ Date ▶ Title

Preparer Other Than Taxpayer Name ▶ Address ▶ Date

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11170F Form **1139** (Rev. 6-2002)

CHAPTER ELEVEN

Tax Priorities and Discharge

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§ 11.1 INTRODUCTION

Tax priorities are important in chapter 7 cases because they determine the order in which unencumbered assets are distributed. For individuals, taxes with priority that are not paid cannot be discharged. Priority of taxes is also significant in chapter 11, because debts with priority must be provided for in full, unless the holder of the claim agrees to different treatment, before the bankruptcy court will confirm a plan. A tax discharge may depend on the extent to which a given tax is a priority tax, whether the taxpayer is a corporation or an individual.

§ 11.2 PRIORITIES

(a) General Provisions

Normally, secured debts are first satisfied and then unsecured debts are paid in the order of priority specified in section 507 of the Bankruptcy Code. The unsecured debts, in their prescribed order, are:

1. Administrative expenses.
2. Unsecured claims in an involuntary case arising after commencement of the proceedings but before an order of relief is granted or a trustee is appointed.
3. Wages earned within 90 days prior to filing the petition (or the cessation of the business) to the extent of $4,925 per individual.
4. Unsecured claims to an employee benefit plan arising within 180 days prior to filing of the petition, limited to $4,925 times the number of employees (less the amount paid in (3) above and the total amount paid by the estate on behalf of the employee to any other employee benefit plan).
5. Claims of grain producers against an operator of a grain storage facility and claims of fishermen against a fish product storage or processing facility to the extent of $4,925 per individual.
6. Unsecured claims of individuals to the extent of $2,225 from deposits of money for purchase, lease, or rental of property or purchase of services not delivered or provided.
7. Allowed claims for alimony, maintenance, or support of a spouse or child in connection with a separation agreement, divorce decree, or other order of a court of record.
8. Unsecured tax claims of governmental units (see §§ 11.2(a)-(i)).
9. Allowed unsecured claims based on any commitment by the debtor to regulation agencies of the federal government to maintain the capital of an insured depository institution.

The dollar accounts in the priorities described above are changed every three years based on the Consumer Price Index for all Urban Consumers. These dollar values are effective through March 31, 2007.

The fifth priority was added by the Bankruptcy Amendments and Federal Judgeship Act of 1984. Thus, for petitions filed prior to October 8, 1984, the fifth priority was the claims of individuals to the extent of $900 (currently $2,225) from deposits for products or services not delivered, and the sixth priority was taxes. The priority for taxes was transferred from a seventh priority to an eighth priority when the Bankruptcy Code was modified in 1994 to include claims for alimony, maintenance, and support payments for spouse or child.

(b) Administration Expenses

First priority among unsecured debts is given to administrative expenses. Included in these expenses is any tax incurred during the administration of the estate while bankruptcy proceedings are in progress (section 503(b) of the Bankruptcy Code). Examples of taxes that would qualify for first priority are income tax liabilities, employees' withholding taxes and the employer's share of empoyment taxes, tax penalties, interest on unpaid taxes, property taxes, excise taxes, recapture of investment tax credit arising from property sales, and claims arising from excessive allowance of "quickie" refunds to the estate (such as tentative net operating loss carrybacks allowed under I.R.C. section 6411).[1] The taxable year to which the carryback adjustment relates may be one that ends either before or after the commencement of the case.[2]

A tax claim shares and shares proportionally with other administrative expenses. The bankruptcy court refused to subordinate a tax claim incurred during the proceeding to that of other costs of administering the debtors' case, and ordered that all of the administrative claims be paid pro rata.[3]

The bankruptcy court noted that there was no basis for subordinating the IRS's claims, pointing out that the estate had admitted its liability for the federal income taxes and had not alleged any misconduct on the part of the IRS. The court noted that the doctrine of equitable subordination developed as a policy against fraud and the breach of duties imposed on a fiduciary of the bankrupt, not a creditor,[4] and that this doctrine has been codified in section 510(c) of the Bankruptcy Code. Equitable subordination is an unusual remedy and should be applied only in limited circumstances.[5]

The court also noted that there is no authority for the equitable subordination of interest on a tax claim. According to the court, interest is an integral part of the tax claim representing actual pecuniary loss to the government, and thus

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[1] Bacon and Billinger, Analyzing the Operating and Tax Effects of the New Bankruptcy Act, 50 *J. Tax'n* 76 (1979).

[2] 11 U.S.C. § 503(b)(1)(C).

[3] *In re Seslowsky*, 182 B.R. 612 (Bankr. S.D. Fla. 1995).

[4] *Pepper v. Litton*, 308 U.S. 295, 311 (1939).

[5] *Matter of Fabricators, Inc.*, 926 F.2d 1458, 1464 (5th Cir. 1991). *See In re Lemco Gypsum, Inc.*, 911 F.2d 1553 (11th Cir. 1990), for a discussion of the limits of equitable subordination.

cannot be subordinated.[6] Dealing with penalties, the court noted that cases that have permitted the equitable subordination of penalties have done so because claims such as penalties were of a "status susceptible to subordination."[7] The court noted that abandoning the property most likely would have permitted the United States to obtain the same cash received by the Trustee while at the same time pursuing the unpaid liability, because the tax liability would not have been dischargeable under sections 507(a)(8) and 523 of the Bankruptcy Code.

Taxes on postpetition payment of prepetition wages would not be a first priority (see §§ 11.2(e)(ii) and 11.2(e)(iii)). Income taxes due for taxable years ending after the petition is filed are administrative expenses. Section 503(b)(1)(C) of the Bankruptcy Code provides that any fine or penalty or reduction in credit relating to a tax classified as an administrative expense is also given first priority. The Fourth Circuit held that the taxes withheld from employees' wages earned after the chapter 11 petition was filed, the employer's share of the FICA taxes, penalties for failure to pay the taxes on time, and interest from the date taxes accrued are all first-priority items.[8] The taxes, penalty, and interest retain first-priority status even when a chapter 11 petition is subsequently converted to a chapter 7 petition. Excise taxes under I.R.C. sections 4971(a) and (b) that are based on funding deficiencies for prepetition plan years were held by the bankruptcy court[9] not to be an administrative expense but an eighth priority. Because the events on which the taxes are based were prepetition, the taxes cannot be administrative expenses.

In determining the dischargeability of a tax during the prepetition period, the bankruptcy court found the prepetition tax to be an eighth priority that was not discharged.[10]

The Second Circuit court held that a trustee is responsible for making estimated corporate tax payments when such payments are required under I.R.C. section 6154.[11]

In *In re Higgins,*[12] the court held that a recapture of investment tax credit on the sale of an asset in a chapter 7 case was not a tax incurred by the estate because the tax did not relate to the estate's use of the property. This decision is questionable in that the tax is not due until the property is sold. The decision to sell the property was made by the trustee. In chapter 7 liquidations, a tax refund that is received after the petition is filed is considered property of the estate. Thus, it does not seem logical to claim that the tax, if owed, is to be paid by the individual, but if a refund exists, it is property of the estate.

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[6] *In re Import and Mini Car Parts, Ltd., Inc.*, 136 B.R. 178 (Bankr. N.D. Ind. 1991).

[7] *Schultz Broadway Inn v. United States*, 912 F.2d 320, 233 (8th Cir. 1990). *See also Burden v. United States*, 917 F.2d 115, 120 (3d Cir. 1990); *In re Virtual Network Servs. Corp. v. United States*, 902 F.2d 1246 (2d Cir. 1990).

[8] *In re Friendship College* 737 F.2d 430 (4th Cir. 1984).

[9] Unimet Corp., 74 B.R. 156 (Bankr. N.D. Ohio 1986). Other courts have held that the excise tax is a penalty and not a tax. See § 11.2(f)(iii).

[10] *In re* O.P.M. *Leasing Serv., Inc.*, 68 B.R. 979 (Bankr. S.D.N.Y. 1987).

[11] *In re Sapphire Steamship Lines*, 762 F.2d 13 (2d Cir. 1985).

[12] 29 B.R. 196 (Bankr. N.D. Iowa 1983).

A different decision was reached regarding a capital gain tax in *In re Lambdin.*[13] The court held that a capital gain tax that incurred liquidation of the estate's assets was an administrative expense and that the debtor would not be liable for this tax because it was an administrative expense of the estate.

The classification as to whether a tax is an administrative expense or an eighth-priority item is critical. For example, if a corporation, in an attempt to reach an out-of-court agreement with creditors, sells assets to make partial payments to creditors at a gain, a substantial tax liability may arise. Assume the corporation concludes that it cannot reach an out-of-court agreement and that it must file a bankruptcy petition. When should the petition be filed? Would it be best for the tax liability to be an administrative expense or an eighth-priority item? If it is an administrative expense, the tax must be paid on or before the effective date of the plan, and interest and penalties will be paid on the tax. If it is an eighth-priority item, it may be deferred up to 6 years (see § 11.2(m)), and interest and penalties will most likely not occur during the case. In this case, it would be best to file the petition after the end of the taxable year in which the property was transferred. It should be noted that at least three Circuits allow a corporation to bifurcate the taxes between pre- and post-filing. Taxes based on income incurred prior to filing prepetition claims and taxes are based on income after the filing are administrative expenses (see § 11.2(b)(ii)). However, if this were an individual with no free assets, it may be better for the petition to be filed before any of the property is transferred and a tax liability is created (see § 4.3(h)).

A nonoperating chapter 7 trustee had no duty to pay postpetition income taxes or accrued postpetition interest on the unpaid taxes before the bankruptcy court approved the administrative claims.[14] The district court noted that the trustee would have violated his Bankruptcy Code duties had he paid the taxes without bankruptcy court approval at the time he filed the 1989 return. The court explained that a non-operating trustee's duty to remit a tax arises when the Bankruptcy Court so orders.

The Sixth Circuit Bankruptcy Appellate Panel affirmed a bankruptcy court decision by holding that section 726 of the Bankruptcy Code does not mandate disgorgement of interim compensation paid to professionals in every case of administrative insolvency.[15]

A U.S. bankruptcy court has held that postpetition property taxes, even though secured, are entitled to priority as an administrative expense because a postpetition real estate tax on property used by the estate is an actual, necessary cost . . . of preserving the estate and hence an administrative expense. The trustee must exhaust unencumbered estate funds before looking to tax liens for payment of administrative expenses.[16] The bankruptcy court noted that the most recently secured tax liens should be the first to be subordinated to administrative expenses. The bankruptcy court also determined that the significant event in

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[13] 33 B.R. 11 (Bankr. D. Tenn. 1983).

[14] *In re Quid Me Broadcasting Inc.*, 1996 Dist. LEXIS 7581 (W.D.N.Y. 1996).

[15] *In re Unitcast Inc.*, 219 B.R. 741 (B.A.P. 6th Cir. 1998).

[16] *In re Brian D. Soltan*, 234 B.R. 260 (Bankr. E.D.N.Y. 1999).

determining if a tax is prepetition or an administrative expense is the date the tax accrues and becomes a fixed obligation.

The Sixth Circuit held that liability for payment of real property taxes did not occur until after the petition was filed, resulting in the liability for payment of taxes as an administrative expense. The Sixth Circuit determined that the taxes were incurred by the estate because no in person right to payment of the taxes existed until the taxes were actually levied after the petition was filed. Although the value and the taxability of the real property was determined prepetition, such determination merely vested in the city an in rem interest in the property, and the taxes thus were not assessed prepetition.[17] This decision reversed the position taken by both the bankruptcy and the district courts that the tax became an obligation at the time

In a legal memorandum,[18] the Service concluded that claims for postpetition taxes in chapter 13 bankruptcy cases should not be filed as administrative expense claims. A debtor filed a motion to modify his chapter 13 plan to add a postpetition liability for federal income taxes that are payable postpetition. The insolvency specialist agreed to allow the debtor to pay the liability through the plan and filed an administrative claim.

The Service concluded that because postpetition tax liabilities are, in chapter 13 cases, incurred by the debtor rather than the bankruptcy estate, characterizing the liabilities as administrative expenses is inconsistent with section 503 of the bankruptcy code. The liability, according to the legal memorandum, should be collected either by filing a claim under section 1305 of the bankruptcy code or by pursuing collection outside of bankruptcy.

(i) Interest and Penalties on Administrative Tax Claims

Section 503(b) of the Bankruptcy Code provides that taxes incurred during the administration of a case and not considered an eighth priority under section 507(a)(8) of the Bankruptcy Code are administrative expenses entitled to first priority.

The bankruptcy court noted that there are three requirements that must be satisfied before penalties will be allowed as an administrative expense:[19]

1. The amount must be in the nature of a fine, penalty, or reduction in credit.
2. The penalty must relate to a tax specified in section 503(b)(1)(C) of the Bankruptcy Code.
3. The penalty must relate to a tax referred to.

The bankruptcy court, then, concluded that a penalty arising from the debtors failure to comply with IRS electronic fund tansfer deposit requirements of Revenue Procedure 97-33 was considered an administrative expense under section 503(b)(1)(C).

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[17] *In re Federated Department Stores, Inc.*, 270 F.3d 994 (6th Cir. 2001).
[18] ILM 200113027; LTRServ, Apr. 9, 2001, p. 1776.
[19] *In re Servint Corporation*, 298 B.R. 579 (Bankr. E.D. Va. 2003).

A question has arisen as to whether interest on these tax claims should be allowed. In *In re Flo-Lizer*,[20] the District Court held that the government is entitled to interest on taxes and penalties as an administrative expense under section 503(b). The court noted that the wording of the statute is ambiguous on the status of interest because, although it does not specifically address interest, the list of allowable claims under the statute is not exhaustive. The court also noted that the statute's legislative history is inconclusive and thus relied on the interpretation of the predecessor statute, under which interest was allowed first-priority status as an administrative expense.

The Eleventh Circuit looked at the same issue.[21] Allied Mechanical Services, Inc., filed a petition and, while operating under chapter 11, incurred withholding tax liabilities. After the chapter 11 was converted to a chapter 7 liquidation, the IRS filed an administrative claim totaling approximately $265,000 for postpetition withholding taxes, penalties, and interest.

The bankruptcy court held, and the District Court affirmed, that the IRS was not entitled to administrative expense priority on its claim for interest on postpetition taxes. However, the Eleventh Circuit reversed the lower court's decision and held that the government's claim for interest on postpetition taxes was entitled to administrative priority under section 503(b) of the Bankruptcy Code. Three other circuits have concluded that section 503(b)(1)(B)(i) includes interest on postpetition taxes.[22] Most of the cases were not just chapter 7 cases, but were either chapter 11 or a chapter 11 converted to chapter 7. The First Circuit, in *In re Weinstein*, addressed the relevance or irrelevance of section 726(a)(5) of the Bankruptcy Code, providing that interest in a chapter 7 liquidation has a number five priority, with the administrative expense provisions in section 523(b), expense incurred during the administration of the case.

Interest as well as penalties accrued on taxes classified as administrative expenses, are allowed as administrative expense. However, in *In re Pool & Varga, Inc.*,[23] the bankruptcy court held that the debtor's financial distress during the bankruptcy constituted reasonable cause for failure to pay income taxes and avoidance of paying related penalties. The court ruled that the financial difficulty of the debtor was not reasonable cause to avoid the penalties for failing to file a tax return. Thus, it would appear that in order to avoid penalties in a bankruptcy case where there is not enough cash to pay taxes classified as administrative expenses, the trustee or debtor-in-possession should file the tax return showing the amount of tax that is due. The taxpayer may indicate on the return that the tax due is an administrative expense in a bankruptcy case and that the tax will be paid when the court authorizes the disbursement.

The bankruptcy court held that the estate is liable for interest and penalties on administrative tax claims arising during the case.[24] A chapter 7 case was con-

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[20] 107 B.R. 143, 89-2 USTC (CCH) ¶ 9616 (S.D. Ohio 1989), *aff'd*, 916 F.2d 363 (6th Cir. 1990).

[21] *In re Allied Mechanical Services*, 885 F.2d 837 (11th Cir. 1989).

[22] *See United States v. Ledlin (In re Mark Anthony Constr., Inc.)*, 886 F.2d 1101 (9th Cir. 1989); *United States v. Friendship College, Inc. (In re Friendship College, Inc.)*, 737 F.2d 430 (4th Cir. 1984). *United States v. Weinstein (In re Weinstein)*, 272 F.3d 39 (1st Cir. 2001).

[23] 60 B.R. 722 (Bankr. E.D. Mich. 1986).

verted to a chapter 13 case and then converted back to chapter 7. The IRS filed claims for priority taxes and interest arising during the period before the case was converted to chapter 13; and claims for administrative taxes, penalties, and interest incurred by the estate during the periods the case proceeded under chapter 13. The trustee objected to these tax claims, arguing that they represented postpetition taxes for which the estate was not liable. The court held that the taxes that accrued prior to conversion are allowable as a priority claim under section 348(d) of the Bankruptcy Code and that the estate is liable for administrative taxes, interest, and penalties incurred while the case proceeded under chapter 13 according to section 503 of the Bankruptcy Code.

In a unanimous decision, the Supreme Court held that bankruptcy courts may not categorically subordinate the IRS's administrative expense claim for a noncompensatory tax penalty to the administrative expense claims of other creditors.[25]

First Truck Lines, Inc., filed for relief under chapter 11 and was subsequently converted to a chapter 7. Thomas Noland was appointed as trustee. The liquidation of the assets of the estate raised funds insufficient to pay all creditors. After the conversion, the IRS filed claims for taxes, interest, and a failure-to-pay penalty accrued during the company's operation as a chapter 11 debtor-in-possession.

The bankruptcy court, while agreeing that the penalties were administrative expenses under section 503(b) of the Bankruptcy Code, justified a preference for compensating actual loss claims and subordinated the tax penalty claim to those of general unsecured creditors. The district court and the Sixth Circuit affirmed.

The Supreme Court explained that, although section 510(c) permits a bankrupt court to make exceptions to the general priority scheme when justified by particular facts or by the misconduct of a creditor, the lower court's general, categorical modification of priorities constituted an impermissible legislative type of decision that Congress already made in establishing the hierarchy of claims in bankruptcy. The lower court's actions, according to the Supreme Court, were directly counter to Congress's policy judgment that a postpetition tax penalty should receive the priority of an administrative expense.

In *In re North Port Associates Inc.*[26] the bankruptcy court held that a secured prepetition tax penalty cannot be equitably subordinated to the claims of general unsecured creditors. In *Noland*[27] and *CF&I,*[28] the Supreme Court held that noncompensatory, post- and prepetition tax penalties on unsecured claims should not be equitably subordinated. The debtor argued that secured prepetition tax penalties can be subordinated because the Bankruptcy Code does not contain an explicit category and priority for such penalties. The court disagreed with the debtor, noting that to carve out the penalty portion of a secured claim and sub-

[24] *In re Ashton Harris Pully, Jr.*, 1989 Bankr. LEXIS 1351 (Bankr. E.D. Va. 1989).
[25] *United States v. Noland*, 116 S. Ct. 1524 (1996).
[26] 1997 Bankr. LEXIS 1082 (Bankr. E.D. Mo. 1997; *aff'd*, 225 B.R. 686 (E.D. Mo. 1998).
[27] *United States v. Noland*, 116 S. Ct. 1524 (1996).
[28] *United States v. Reorganized CF&I Fabricators*, 518 U.S. 213; 116 S. Ct. 2106 (1996).

ordinate it to a nonpriority unsecured status would be an equitably oriented, judicially imposed policy decision overriding specific congressional mandate.

The Tenth Circuit held that tax debts and interest are nondischargeable under section 1141(d)(2) of the Bankruptcy Code only when a governmental entity holds an unsecured claim and not a secured claim. The IRS neither asserted a claim for gap period interest nor objected to the debtors' confirmed plans, which made no allowance for payment of such interest. The court concluded that postpetition, preconfirmation interest accruing on a secured IRS claim in a chapter 11 case is dischargeable. The circuit court rejected the IRS's position that gap interest survived the dischargeability provisions of section 1141(d), which excerpts from discharge debts listed in sections 523 and 507. The Tenth Circuit agreed with the reasoning of the district court that because the tax claims were secured, they did not qualify as allowed unsecured claims that were exempt from discharge under section 507(a)(8) of the Bankruptcy Code.[29] Other courts[30] have reached a different interpretation of this issue as discussed below in §11.3(b)(viii).

The Sixth Circuit Bankruptcy Appellate Panel affirmed a bankruptcy court decision by holding that the Service's claim for I.R.C. section 4971 pension excise taxes was not a postpetition claim entitled to priority as an administrative expense.[31] After the petition was converted to chapter 7, the IRS moved to have the professionals disgorge the fees they received in chapter 11 on the ground that they had received more than their pro rata share. The appellate panel concluded that pension excise taxes were penalties that did not relate to a tax incurred by the estate and thus were prepetition liabilities.

In *In re Schreiber*,[32] the bankruptcy court ruled that, because the IRS was oversecured, it is entitled to postpetition interest from the date the petition was filed until the date the secured claim is fully paid.

(ii) Bifurcation of Corporate Taxes

Section 1399 provides that a new tax entity is not created for federal income tax purposes when the corporation files a bankruptcy petition. Thus, for federal income tax purposes the corporation in bankruptcy will determine the income tax liability in its normal manner for the entire year. However, this unresolved issue remains: how is the tax that relates to the period before the petition was filed handled for bankruptcy purposes? For example, in a year in which the petition is filed, is the tax for the entire year an administrative expense? Or should the tax liability be bifurcated—the tax liability for the period from the beginning of the taxable year to the day before the petition was filed and the tax liability for the period after the petition was filed until year-end? The tax liability for the period ending just before the petition was filed would be an eighth priority tax claim and in a chapter 11 case could be deferred over a period of six years from the date the tax was assessed. In contrast, the tax liability for the period after the

[29] *In re Vicotor*, 121 F.3d 1383 (10th Cir. 1997).
[30] For example, *see In re Hornick*, 1999 Bankr. LEXIS 1617 (Bankr. W.D. Pa. 1999).
[31] *In re Unitcast Inc.*, 219 B.R. 741 (Bankr. 6th Cir. 1998).
[32] 163 B.R. 327 (Bankr. N.D. Ill. 1994).

petition is filed would be an administrative expense and thus must be paid during the administration of the case. The Service position is that the entire tax liability for a year ending after the petition is filed is an administrative expense.

The Eleventh Circuit, in *In re Hillsborough Holdings Corp.,*[33] Ninth Circuit, in *In re Pacific-Atlantic Trading Co.,*[34] and the Eighth Circuit, in *In re L.J. O'Neill Shoe Co.,*[35] held that the tax should be bifurcated between the prepetition and postpetition periods for the purpose of determining the priority of the tax liabilities. These courts focused on the language in section 507(a)(8)(A)(iii) describing taxes that were "not assessed before, but assessable under applicable law or by agreement, after the commencement of the case." All three courts concluded that this language includes taxes attributable to the prepetition period, because such taxes are not assessed before and do not become assessable until after the bankruptcy filing when the tax year closes; however, they realized that a literal interpretation of this phrase would also imply that postpetition taxes also fall under this section. These circuits based on legislative history and analysis, agree that section 507(a)(8) was only intended to deal with prepetition taxes. Thus, taxes based on income earned during the prepetition period are eighth priority.

(c) "Involuntary Gap" Claims

Creditors whose claims arise in the ordinary course of the debtor's business or financial affairs after any involuntary case is commenced, but before a trustee is appointed or the order for relief is entered by the court, are granted second priority. Thus, any taxes arising during this period would receive second priority.

(d) Prepetition Wages

Claims for wages up to $4,925[36] per employee earned within 90 days before the filing of the petition receive third priority. Any taxes withheld on these wages would receive the same priority according to Bankruptcy Code section 346(f). Thus, withholding taxes on wages earned prior to the 90-day period and on wages earned by individuals in excess of the $4,925 limit would not receive any priority. These claims would be classified with other general unsecured claims. Claims that fall within the 90-day period and the $4,925 limit would receive third priority. Note that this provision applies only to prepetition wages that were not paid. Wages that are received in the form of a check in a tax year and are then returned the following year as unpaid due to the filing of a chapter 11 petition were held by the IRS[37] not to be income to the taxpayer. A check is treated as a conditional payment of cash—the check must be honored and paid

[33] 116 F.3d 1391 (11th Cir. 1997).
[34] 64 F.3d 1292 (9th Cir. 1995).
[35] 64 F.3d 1146 (8th Cir. 1995).
[36] All of the dollar amounts are effective through March 31, 2007. Effective April 1, 2007, the dollar amounts will be revised, based on the changes in the Consumer Price Index for all Urban Consumers for the year period ending December 31, 2006, and remain effective for the next three years.
[37] Private Letter Ruling 8606012 (Nov. 5, 1985).

by the bank on which it is drawn. In this case, because the checks were returned, payment was not received.

(e) Prepetition Tax Priority

Certain taxes are granted eighth priority. The Bankruptcy Code continues the policy of requiring the creditors of a bankrupt to pay the taxes owed by the debtor, because the payment of taxes reduces the amount that general unsecured creditors would otherwise receive. The Bankruptcy Code makes some modifications in the taxes that are granted priority status, and it attempts to solve some of the unresolved questions of the prior law. For a claim to receive an eighth priority, it must be a tax claim owed to the federal government or to a state or local taxing authority. The courts have ruled that an obligation to the Pension Benefit Guaranty Corporation (PBGC) is not a tax even though 29 U.S.C. section 1368(c)(2) provides that an ERISA lien for employer liability is created and treated under I.R.C. section 6323 like a tax lien. Even though the PBGC claim is treated as a tax lien, "Section 1368 does not state that the underlying ERISA liability is a tax liability."[38] Often, these obligations have not been perfected at the time the petition is filed and as such are unsecured claims, because they are not an eighth-priority unsecured tax claim.[39]

In a chapter 13 case, the bankruptcy court held that prepetition child support obligation assigned to the IRS under section 6305 is entitled to priority as if it was a tax under section 507(a)(8) of the Bankruptcy Code.[40] The court noted that I.R.C. section 6305 states that the obligation is to be treated as if it were a tax under Subtitle C, and it may therefore be treated as if it were a tax under Bankruptcy Code sections 507(a)(8)(C) and (D).

The bankruptcy court, in *In re Distiller's Pride Corp.*,[41] has held that claims of the Bureau of Alcohol, Tobacco, and Firearms for excise taxes, interest, and penalties are allowed as priority taxes. The court ruled that the fact that the taxing authority knew of the taxpayer's unlawful conduct but failed to notify it of such conduct did not change the nature of the tax liability.

If there are not enough funds in the estate to pay all tax claims, then the amount available is distributed on a pro rata basis. In *In re Sylvania Corp.*,[42] a chapter 7 case, the District of Columbia (the District) filed a priority claim for unpaid sales taxes of about $133,000 and the IRS filed a priority claim for $16,500 in unpaid federal taxes when only about $21,000 was available for distribution to priority claims. The District argued that it had priority over the IRS under section 724(b) of the Bankruptcy Code because it held a senior lien under District law, but the federal government argued that it was entitled to a pro rata portion of the distribution because neither the District nor the IRS had a lien. Of course if

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[38] *In re Divco Philadelphia Sales Corp.*, 60 B.R. 323 (Bankr. E.D. Pa. 1986).

[39] *In re Chateaugay Corporation (LTV)*,130 B.R. 690 (S.D.N.Y. 1991).

[40] *In re Gillespie Jr.*, 1996 Bankr. LEXIS 704 (Bankr. D. Minn. 1996).

[41] 58 AFTR 2d (P-H) 6412 (Bankr. W.D. Ky. 1987).

[42] 1991 Bankr. LEXIS 1740 (Bankr. D.D.C. 1991); *see In re University Wine & Liquors, Inc.*, 1991 Bankr. LEXIS 2108 (Bankr. D.D.C. 1991).

either had their claim secured by a lien, the entity with a tax lien would have priority.[43]

(i) Income and Gross Receipts Taxes

Section 507(a)(8)(A) of the Bankruptcy Code contains several provisions granting priority to income and gross receipts taxes. Gross receipts are not defined in the Bankruptcy Code. A sales tax under California state law is a gross receipts tax because it is levied against the seller and not the purchaser of the goods.[44] The Bankruptcy Appellate Panel (BAP) for the Ninth Circuit rejected the debtor's contention that a sales tax in California was not a gross receipts tax because section 507(a)(8)(A) says "gross receipts"; that in order to come within the statute, California's tax must in fact be calculated based on the total receipts of a taxpayer; and that a tax on anything less than all of those receipts is not a tax on gross receipts.

The California State Board of Equalization argued that because the state statute starts with the total receipts of the taxpayer in calculating the tax, the statute is a tax on gross receipts and is therefore nondischargeable pursuant to sections 523(a) and 507(a)(8)(A). The BAP concluded that the

> better approach is to recognize that the tax assessed . . . is a tax on or measured by gross receipts and would therefore be nondischargeable pursuant to sections 507(a)(8)(A) and 523(a)(1)(A). There is no indication in the statute itself, or in any secondary authority, that Congress intended the term 'gross receipts' to have a strict federal definition rigidly limited to those situations where a tax is imposed on total receipts without exclusion.[45]

The BAP noted that the California tax is in a true sense "measured by" gross receipts. That is, the amount of the taxpayer's total receipts is an integral initial component of the formula with reference to which the amount of the tax is determined, and not merely a method of apportioning liability for a tax already calculated in some other fashion.

The court examined the decision in *In re George*[46] where the Ninth Circuit BAP held that the California sales tax was a "tax" for purposes of excepting the obligation from discharge under section 523(a)(1)(A). The bankruptcy court had held that the tax was an excise tax under section 507(a)(8)(E); however, the BAP did not review this conclusion. The BAP in the *George* decision noted that there "may be a question as to whether the bankruptcy court correctly determined that the 'sales tax' in this case should be considered an 'excise tax' under section 507(a)(8)(E) rather than a 'trust fund tax' under section 507(a)(8)(C) or a 'tax on or measured by gross receipts' under section 507(a)(8)(A)."

The court concluded in *Raiman* that because the sales tax is a gross receipts tax and therefore excepted from discharge, it was not necessary to decide whether the sales tax under California law might also be an excise tax.

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[43] *Pearlstein v. U.S. Small Business Admin*. 719 F.2d 1169 (D.C. Cir. 1983).
[44] *In re Raiman*, 172 B.R. 933 (Bankr. 9th Cir. 1994).
[45] *Id*.
[46] 95 B.R. 718 (Bankr. 9th Cir. 1989), *aff'd*, 905 F.2d 1540 (9th Cir. 1990).

In *In re O.P.M. Leasing Services, Inc.*,[47] the bankruptcy court was asked to determine whether a claim filed by the state under the Texas franchise tax law was entitled to priority under section 507(a)(8)(A). The state statute fixed the amount of the tax due from a corporation based upon the value of its capital. However, when a company also did business in other states, only that portion of the capital allocated to Texas under the statutory formula was taxed. The capital was allocated between states based on that portion of the corporation's gross receipts generated within Texas as compared to elsewhere.

In finding that the Texas tax was not a gross receipts tax for purposes of the bankruptcy priority provisions, the court concluded:

> The mere mention of gross receipts in the § 171.106 [Tex. Tax Code Ann.] formula does not automatically activate § 507(a)(8)(A) and accord the State priority status. The State, however, makes precisely such an argument, ascribing an extraordinarily broad meaning to the word "measure" to encompass the word "allocate." This interpretation would emasculate the words of § 507(a)(8)(A), and would render the strict construction of the § 507(a)(8)(A) priority statute meaningless. The gross receipts ratio has no impact on the measurement of the tax as it relates to capital, and thus the tax in actuality is not on or measured by gross receipts.[48]

Citing *In re Parrish*,[49] the bankruptcy court held that because the trustee did not comply with the requirements of Bankruptcy Rule 6004, the assets were not sold free and clear of liens.[50] Thus, the tax liens remained attached to the assets and did not attach to the sale proceeds held by the trustee. Therefore, the tax claim in bankruptcy was a priority tax and not a secured claim. The debtor purchased the four assets from the trustee of his estate.

In *In re Alquist*,[51] the district court determined that the tax on the lump sum distribution for a profit plan was a priority tax under I.R.C. section 507(a)(8)(A)(i) and, as a result, was not dischargeable. The court rejected the argument that the proceeds were not income within the meaning of income in section 507 of the Bankruptcy Code.

The Fourth Circuit, in a *brief per curiam* opinion, upheld a decision of the district court, holding that the tax on a lump sum distribution from a pension plan was not dischargeable under chapter 7, because the tax was a priority tax under section 507(a)(8)(A)(i) of the Bankruptcy Code and distribution was received within three years of the bankruptcy filing.[52]

(A) Three-Year Period

First, any tax on income or gross receipts for a taxable year ending on or before the date of the filing of the petition is given eighth priority, provided the date the return was last due, including extensions, was later than 3 years before the petition was filed. If a bankruptcy petition is filed on May 1, 1995, any

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[47] 60 B.R. 679 (Bankr. S.D.N.Y. 1986).
[48] *Id.* at 682.
[49] 171 B.R. 138 (Bankr. M.D. Fla. 1994).
[50] *In re Cutaia*, 206 B.R. 250 (Bankr. S.D. Fla. 1997).
[51] 172 B.R. 828 (W.D.N.C. 1994), *aff'd without opinion*, 60 F.3d 820 (4th Cir. 1995).
[52] *John J. Alquist v. Commissioner*, 1995 U.S. App. LEXIS 16641 (4th Cir. 1995).

unpaid taxes due on a 1991 tax return filed on March 1, 1992, would not be a priority item. The return due date of April 15, 1993, is more than 3 years prior to the petition date of May 1, 1995. If the petition were filed on April 14, the taxes would be an eighth priority even though the return was filed on March 1, because the date when the return is due is used rather than the date when the return was filed. Any tax due for a taxable period that ended after the petition was filed is not granted eighth priority but would be considered an administrative expense (first priority). The date-of-the-return test of the Reform Act replaces the section 17(a)(1) requirement of the Bankruptcy Act of "legally due and owing," which was unclear and caused debate.[53]

The filing date, and not a subsequent conversion date, should be used for purposes of determining the 3-year look-back dischargeability period.[54]

An extension that was filed for a tax year in which the couple's tax return was filed on time was held to be valid.[55] The district court disagreed with the bankruptcy court and held that:

- The "lookback" period commenced on the date the tax was "last due, including extensions"—not the date the return was filed.
- The mere fact that an extension was not used did not make it void.
- Even though the extension application failed to accurately set forth the amount of taxes due, it was only the government who could determine that the automatically granted extension was ultimately void, terminated, or revoked.
- The debtors could not raise their own noncompliance with the requirements for obtaining an extension to assert that the extension was void to attempt to discharge their tax liability through bankruptcy.

Section 507(a)(8)(A)(i) of the Bankruptcy Code provides that, if an extension has been granted, the tax will not be discharged if the last extension deadline is within 3 years of the bankruptcy filing. In *In re Wood*,[56] the debtor filed his tax return on October 7, 1983, where the last extension deadline was October 15, 1983. On October 10, 1986, over 3 years after the tax return was filed but within the 3 years from the last extension deadline, a chapter 7 petition was filed. The court ruled that the taxes were nondischargeable because the bankruptcy petition was filed within 3 years of the due date of the last extension.

In *In re Lamborn*,[57] the bankruptcy court held that an amended return is a return for purposes of section 507(a)(8)(A)(i), and thus the tax resulting from the filing of the amended return is not dischargeable for three years. As noted in § 11.3(b)(iv), an amended fraudulent return is not generally considered a return.

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[53] *In re Bishop*, 209 B.R. 578 (N.D. Ga. 1997) (timely return filed in October 1992 with extension and petition filed September 1995).

[54] *In re Palladino*, Adv. No. 95-0081-BKC-PGH-A (Bankr. S.D. Fla. Sept. 21, 1995). *See In re Rassi*, 140 B.R. 490 (Bankr. C.D. Ill. 1992).

[55] *In re McDermott*, 286 B.R. 913 (M.D. Fla. 2002).

[56] 78 B.R. 316 (Bankr. M.D. Fla. 1987).

[57] 181 B.R. 98 (Bankr. N.D. Okla. 1995).

A bankruptcy court held that a debtor's 1992 taxes were not dischargeable, because although the debtor filed his return more than 3 years before filing for bankruptcy, the extended due date for the return was within the 3-year priority period under section 507(a)(8) of the Bankruptcy Code.[58] The taxpayer filed his 1992 return in July 1993 and filed his chapter 7 petition more than 3 years later, on August 1, 1996. The court ruled that the plain language of the statute refers to the date the return is due, including extensions.

Because the IRS is prohibited from taking action during the time that a bankruptcy case is pending, the Supreme Court[59] held that the 3-year lookback period is tolled during one or more bankruptcy filings. The 3 year period is extended by the time that the automatic stay was in effect for prior bankruptcy case or cases.

In *Henry E. Montoya v. United States*,[60] the bankruptcy court also held that the time during which a prior bankruptcy case that was subsequently dismissed was pending should not be considered in determining the 3-year period. The IRS argued that it was prevented from pursuing its claim because of the stay that was in effect during the prior bankruptcy, and the court agreed. In this case, the tax claim was disputed under the prior filing, and a hearing was never held on the claim before the case was dismissed.

Chapter 13 petitions were filed by individual partners. The IRS subsequently filed proofs of claim for taxes assessed against the partnership. The bankruptcy court held that because the Service under I.R.C. section 6203 had not assessed the partners individually, they had no tax liability. The district court affirmed and noted that because the 3-year statute of limitations for assessment under section 6501(a) had expired, the Service's claim was disallowed.[61]

(B) Assessed within 240 Days

A second provision is that any income or gross receipts tax must be assessed within 240 days before the petition was filed, even though the due date of the return does not fall within the 3-year period discussed above. The purpose of the 240-day provision is to give the IRS time to take more drastic measures to collect the tax.

For federal tax purposes the assessment date is the date that an assessment officer signs the summary record of assessment.[62] For example, the tax was determined to have been assessed when notice is recorded, according to the

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[58] *In re Padden*, 1997 Bankr. LEXIS 1895, 80 A.F.T.R.2d (RIA) 8246 (Bankr. M.D. Pa. 1997).

[59] *Young v. United States*, 535 U.S. 43, 122 S. Ct. 1036 (2002).

[60] 1990 Bankr. LEXIS 2797 (Bankr. S.D. Ind. 1990), *aff'd*, 1991 U.S. Dist. LEXIS 10672 (S.D. Ind. 1991).

[61] *States v. Briguglio*, 2001 U.S. Dist. LEXIS 4829 (C.D. Ca. Mar. 23, 2001).

[62] *In re Lilly*, 194 B.R. 885 (Bankr. D. Idaho 1996) (the assessment date for dischargeability purposes is the date when the Service enters the assessment pursuant to I.R.C. section 6203). *In re Bernicky*, 1996 Bankr. LEXIS 784 (Bankr. N.D. Ind. 1996) (when the summary record of assessment is signed by the assessment officer). *In re Hays*, 166 B.R. 946 (Bankr. D. N.M. 1994)(the Certificate of Assessments and Payments constitutes presumptive proof of a valid assessment).

District Court in *Willis E. Hartman v. United States.*[63] The IRS mailed a notice on September 9, 1986, and formally assessed the tax on November 26, 1986, when it issued Form 3552 to the taxpayer. With the issuance of this form, the IRS sent Form 870, which would permit Hartman to consent to the assessment of the deficiency. On June 25, 1987, Hartman filed a bankruptcy petition. Hartman argued that the tax assessment should be discharged because it was made on September 9, 1986, which was more than 240 days before the bankruptcy petition was filed.

The IRS, citing I.R.C. section 6203 and cases interpreting that provision, argued that the assessment was not made until November 26, 1986, the date on which a certificate of assessment was recorded at the Treasury Department. The bankruptcy court held that the tax was assessed when the IRS determined the deficiency. The court said that after the deficiency notice was issued, the IRS "was simply going through its process before taking the final recording of the assessment under its statutes and regulations."

The District Court reversed the bankruptcy court's decision and held that the 1983 deficiency was assessed on November 23, 1986—the date when the certificate of assessment was recorded at the Treasury Department. The court explained that the term "assessment" is not defined in the Bankruptcy Code, that it is specifically used in reference to taxes and its meaning must be a function of that context, and that Congress left its particular meaning to depend on the particular tax procedures.

In the case of an assessment resulting from a judgment, it was determined that the date of assessment was not the date that the Tax Court enters a judgment, but the date that the IRS subsequently assesses the tax resulting from the judgment.[64]

It is important for the debtor to determine the exact date when the tax was assessed. In the case of a federal tax, the debtor may attempt to obtain a copy of Form 23-C, "Assessment Certificate," or an official statement from the IRS verifying that the debtor is listed on the summary record. A general statement as to the assessment date by a representative of the taxing authority may not be adequate. In *In re King*,[65] the debtor and his tax adviser inquired, with the intent of timing of filing of the petition to have the tax considered dischargeable, from the supervisor at the California Franchise Tax Board as to the assessment date. The debtor relied on the oral representation and filed his petition accordingly. After the taxpayer's discharge, the IRS attempted to collect the tax. The California Tax Code and its regulations do not refer to any formal act of assessment recordation. The Ninth Circuit BAP held that the court had to determine when the tax was assessed. In *King*, the court ruled that the tax was not assessed less than 60 days after the issuance of the notice of the proposed additional tax. This date was within 240 days before the petition was filed and, as a result, the tax was not discharged.

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[63] 110 B.R. 951 (D. Kan. 1990); *see also In re Oldfield*, 121 B.R. 249 (Bankr. E.D. Ark. 1990); and *In re Shotwell*, 120 B.R. 163 (Bankr. D. Ore. 1990).

[64] *In re Hardie*, 204 B.R. 944 (S.D. Tex. 1996).

[65] 122 B.R. 383 (Bankr. 9th Cir. 1991), *aff'd*, 961 F.2d 1423 (9th Cir. 1990).

The 240-day period is determined beginning on the day before the bankruptcy petition was filed and counting backward for 240 days. If the 240th day is a Saturday, Sunday, or legal holiday, then the preceding day would be used. If the assessment was made on or after that date, it is still in effect.

Offer in Compromise

If during this 240 day period an offer in compromise is made, the time from when the offer is made until it is accepted, rejected, or withdrawn is not counted. Furthermore, the tax will automatically be given priority if the petition is filed within 30 days after the offer was rejected or withdrawn or if the offer in compromise is still outstanding, provided the offer in compromise was made within 240 days after the assessment. Section 108(c) of the Bankruptcy code provides that if nonbankruptcy law fixes a period in which action may be taken against the debtor, the period will be extended until the end of such period plus 30 days. However, if a bankruptcy petition was filed during this time period it may be extended for an additional 6 months as provided under section 6503.

A question has arisen as to the timing of the offer in compromise to determine whether the period is tolled. Section 507(a)(8)(A)(ii) of the Bankruptcy Code provides, in reference to a priority tax, that a tax is a priority tax and thus is not subject to discharge if "assessed within 240 days, plus any time plus 30 days during which an offer in compromise with respect to such tax that was made within 240 days after such assessment was pending, before the filing of the petition. . . ." In *In re Aberl*,[66] the bankruptcy court held that the 240-day rule was tolled only by offers in compromise made within 240 days after an assessment, construing that word from the statute literally. However, in *In re Cumiford*,[67] the district court applied the tolling provision to offers in compromise made before the assessment. The *Aberl* court concluded that the *Cumiford* decision had improperly rendered the words "after such assessment" superfluous. On appeal, the Sixth Circuit held that an offer in compromise made prior to the assessment is not impacted by the 240-day period.[68]

The bankruptcy court held, for purposes of the exception to discharge in section 507(a)(8)(A)(ii) of the Bankruptcy Code, that the time during which an offer was pending before the IRS did not include the time between the Service's receipt of the offer and the date of the taxpayer's amendment of the offer to provide additional information necessary to make the offer valid.[69]

In re Klein,[70] the district court concluded that the 240-day priority period stops running when an offer is accepted for processing and starts running again when the offer is rejected, even if the taxpayer is appealing the decision of the Service.

[66] 159 B.R. 792 (Bankr. N.D. Ohio 1993), *aff'd*, 78 F.3d 241 (6th Cir. 1996).
[67] Adv. No. 87-0013 (D. Haw. 1988).
[68] 78 F.3d 241 (6th Cir. 1996).
[69] *In re Romagnolo*, 195 B.R. 801 (Bankr. M.D. Fla. 1996).
[70] 189 B.R. 505 (C.D. Cal. 1995).

In *In re Hobbs*,[71] the bankruptcy court ruled that a tax debt was dischargeable under the 240-day rule of section 507(a)(8)(A)(ii) of the Bankruptcy Code. The court rejected the Service's argument that an offer in compromise was still pending after the agency told the taxpayer that he would have to submit a new offer and concluded that the IRS letter terminated the offer.

In *In re Callahan*,[72] the bankruptcy court held that I.R.C. section 507(a)(8)(A)(ii) translates into a fairly simple formula. The bankruptcy court need only determine whether the tax was assessed within (x) days before the debtor filed his petition in bankruptcy, where (x) is the sum of 240, 30, and any time during which a qualifying offer in compromise was pending. If the tax was assessed within (x) days before the bankruptcy filing, the debt is excepted from discharge; if the tax was assessed more than (x) days before the filing, it is not excepted from discharge by virtue of I.R.C. section 507(a)(8)(A)(ii). The parties agreed on this formula and on the relevant facts.

All of the tax debt was assessed on April 6, 1988, and the debtor filed his bankruptcy petition 1,489 days later, on May 4, 1992. In the meantime, the debtor filed two offers in compromise with the IRS. The first was filed on August 15, 1988, and rejected on May 30, 1990. As a result, the first offer was pending a total of 653 days. The second offer was filed on July 9, 1990, and rejected on July 7, 1992. As a result, the second offer was pending a total of 664 days before the bankruptcy petition was filed.

The bankruptcy court then noted that the calculation is straightforward. The debtor filed one offer in compromise on August 15, 1988, within 240 days after the tax was assessed. The August 15 offer was pending a total of 653 days. Therefore, the number of days within which the petition must have been filed after the taxes were assessed was 923 days (240 + 30 + 653). Because the taxes were assessed more than 923 days before the bankruptcy petition was filed, the bankruptcy court held that the taxes were not of the kind and for the period specified in I.R.C. section 507(a)(8)(A)(ii).

The IRS has disagreed with this conclusion, taking the position that the second offer in compromise should also be deemed a qualifying offer. The IRS reaches this conclusion on the basis of its argument that the filing of an offer in compromise tolls the 240-day period during which an offer in compromise needs to be filed in order to be a qualifying offer for purposes of the formula set forth above. Thus, according to the position of the IRS, the debtor's second offer in compromise would be deemed a qualifying offer because, if the time during which the first offer was pending is not counted, the second offer was filed less than 240 days after the date of assessment.

While it may seem that, if other courts continue to determine the impact of the offer in compromise in this manner, the taxpayer benefits, in actuality the IRS and other taxing authorities may be encouraged to file liens on the property while an attempt is being made to develop a compromise. Often, while the debtor is attempting to reach a compromise with the IRS, negotiations are being

[71] 1996 Bankr. LEXIS 698, 97-1 U.S. Tax Cas. (CCH) ¶ 50,127, 78 A.F.T.R.2d (P-H) 5252 (Bankr. N.D. Iowa 1996).

[72] 168 B.R. 272 (Bankr. D. Mass. 1993).

held in an attempt to develop an out-of-court workout. The filing of the tax liens may make it difficult to complete the workout.

In *Bilski v. Commissioner*,[73] the Tax Court held that the filing of a bankruptcy petition does not terminate the extension of time under Form 872-A. Stanley and Connie Bilski executed a Form 872-A consent to extend the assessment period regarding their 1982 return; subsequently, they filed a chapter 7 petition. The bankruptcy court relieved the Bilskis of all dischargeable debts. A year later, the IRS issued a notice of deficiency for 1982, which the Bilskis contested, arguing that the bankruptcy court had discharged them from the obligation to pay their taxes for 1982.

The court explained that a properly executed Form 872-A may only be terminated through the mechanisms specifically provided on the form, including the taxpayers' or the IRS's mailing of a Form 872-T (Notice of Termination) to the other party, and the IRS's mailing of a notice of deficiency. The Tax Court did not accept the Bilskis' contentions that the Form 872-A terminated 60 days after they filed the bankruptcy petition or lost its character as a voluntary waiver when they filed. The court suggested that the Bilskis could have terminated their Form 872-A by mailing a Form 872-T to the IRS before filing for bankruptcy.

Impact of Bankruptcy Filing

The Sixth Circuit Bankruptcy Appellate Panel held that the period in which the IRS must collect taxes is suspended during a debtor's prior bankruptcy case under section 6503(h), even when the debtor had previously agreed to an extension of the deadline under section 6502(a)(2).[74] The Sixth Circuit BAP explained that a bankruptcy filing can extend a deadline in two ways: (1) under 11 U.S.C. section 108(c) or (2) applicable nonbankruptcy law. The BAP held that section 108(c) did not alter the applicable nonbankruptcy statute (section 6503(h)) in this case. The court rejected the debtor's argument that the IRS waived the application of section 6503(h) when it failed to incorporate that section into the debtor's initial waiver agreements.

If the petition is filed 240 days after the assessment, the tax does not have any priority unless it falls within the 3-year period.

In *In re West*,[75] the Ninth Circuit held that the time period for the IRS to collect on a tax after it has been assessed is stayed during the time a petition is filed, even though the stay may extend to dismissal plus six months.

Citing *In re Brickley*,[76] the Ninth Circuit noted that the debtors' joint chapter 13 case suspended the running of the 240-day priority period under section 507(a)(8)(A)(ii) of the Bankruptcy Code from the date of the bankruptcy petition until six months after the case was dismissed, and, accordingly, the IRS claims were entitled to priority. By incorporating the suspension provisions of the Internal Revenue Code, the Ninth Circuit stated that section 108(c) of the Bankruptcy Code reflects a policy determination that it would be unfair to allow the

[73] 67 T.C.M. (CCH) 2150 (1994), *aff'd* 69 F. 3d 64 (5th Cir. 1995).
[74] *In re Klingshirn*, 209 B.R. 698 (Bankr. 6th Cir. 1997); *aff'd* 147 F.3d 526 (6th Cir. 1998).
[75] 5 F.3d 423 (9th Cir. 1993).
[76] 70 B.R. 113 (Bankr. 9th Cir. 1986).

statute of limitations to run against the government's right to enforce a tax lien when, even if the government did bring suit, it couldn't collect because it couldn't get at the taxpayer's assets. The court then reasoned that the six-month extension period of I.R.C. section 6503 reflects a legislative recognition that interruption in collection activity requires additional time once the IRS is again free to pursue tax debtors.

The Eighth Circuit[77] concluded that 11 U.S.C. section 108(c) and section 6503(b) and (h) suspended the 3-year priority period during the time that the IRS was precluded by the automatic stay from collecting outstanding tax debts.

The Third and Seventh Circuits held that the filing of a prior bankruptcy petition suspends the running of the 240-day priority period.[78] In a legal memorandum[79], Kathryn A. Zuba, Chief, Branch 2 (Collection, Bankruptcy & Summonses), has concluded that taxes can be claimed as priority on proofs of claim based on tolling as long as the tolling is justified on a case-by-case basis and the Service's reliance is indicated on the proof of claim. This memorandum was issued following the Sixth Circuit's decision in *Palmer v. U.S*. Under *Palmer*, as noted above, priority periods were not tolled automatically during prior bankruptcy cases, but may be tolled on a case-by-case basis.

The memorandum explains the Service's position that taxes can be claimed as priority on proofs of claim based on tolling as long as the Service determines that tolling is justified on a case-by-case basis. Zuba recommended, however, that the precise factors the Service relies on to select cases for which tolling will be claimed should be developed by the local counsel offices based on local case law. The memorandum also recommended that the Service establish that the debtor is abusing the bankruptcy system by filing multiple bankruptcy.

However, the Fifth Circuit held that the plain language of the statute compels the court to hold that a prior bankruptcy does not suspend the running of the 240-day priority period.[80] It should be realized that this decision as well as the memorandum described above was issued prior to the Supreme Court's decision in *Young v. United States.* See § 11.2(e)(i)(A).

The bankruptcy court[81] held that the IRS was entitled to a priority claim in an individual's bankruptcy case, because the individual's prior bankruptcy filing tolled the 240-day assessment period of 11 U.S.C. section 507(a)(8).[82]

A bankruptcy court held that the three-year look-back period of 11 U.S.C. section 507(a)(8)(A)(i) is suspended six months by section 6503 for each of a

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[77] *In re Waugh*, 109 F.3d 489 (8th Cir. 1997); *cert. denied* 118 S. Ct. 80 (1997).

[78] *In re Taylor*, 81 F.3d 20 (3d Cir. 1996); *Montoya v. United States*, 965 F.2d 554 (7th Cir. 1992).

[79] ILM200051039; LTRServ, January 1, 2001, p. 7246.

[80] *In re Quenzer v. United States*, 19 F.3d 163 (5th Cir. 1993).

[81] *In re Hoppe*, 259 B.R. 852 (Bankr. E.D. Tex. 2001).

[82] In reaching its decision the court relied on *In re Bair.* 240 B.R. 247, 251 (Bkrtcy. W.D.Tex. 1999) ("Courts have utilized section 105(a) to equitably toll the three year and 240 day limitations periods for tax claims during the pendency of a debtor's previous bankruptcy case." Citing to *In re Richards,* 994 F.2d 763, 765-66 (10th Cir. 1993) (tolling 240 day period)); *Ramos v. IRS (In re Ramos),* 208 B.R. 655, 658 (W.D.Tex. 1996) (tolling both three-year and 240-day periods).

debtor's prior bankruptcy petitions.[83] Citing *In re Montoya*,[84] and *In re Dodson*,[85] the bankruptcy court held that the IRS is entitled to a six-month credit for each bankruptcy petition, provided that the time between a case's dismissal and a subsequent petition exceeds six months. The court in *In re Dodson* emphasized that the purpose of section 6503 is to give the IRS ample time to restart and refocus its collection efforts once able to do so.

In *In re William E. Richards*,[86] the district court also held that the time during which a bankruptcy case was pending that was subsequently dismissed is not considered in determining the 240-day assessment period. The court, citing *In re Brickley*,[87] held that I.R.C. section 6503(b), applicable to bankruptcy cases through section 108(c) of the Bankruptcy Code, suspended the running of the collections period provided in sections 507 and 523 of the Bankruptcy Code during Richards' first bankruptcy.

In *William O. Blank v. United States*,[88] the bankruptcy court held that, in counting the time for the 240-day assessment period, the time for a second assessment is considered in determining if the tax is a priority tax. The court cited *In re Frary*[89] in holding that the tax was assessed within 240 days prior to the filing of the petition.

(C) Tax Is Assessable

The third provision grants priority to any income or gross receipts tax that has not been assessed but that is assessable. Thus, even though a tax was due more than 3 years ago, it is still granted priority, provided the tax is assessable. Taxes that are nondischargeable under Bankruptcy Code section 523(a)(1)(B) and (C) are excluded from this provision. Examples of taxes that qualify under this provision are claims still being negotiated at the date of petition, previous years' taxes for which the taxpayer has extended the statute of limitations period, taxes in litigation where the tax authority is prohibited from assessing the tax, or any other unassessed taxes that are still open under the statute of limitations.[90]

An assessment does not become effective until the issue is resolved if there is a protest before the expiration of a time period the taxpayer has to file a protest. The Ninth Circuit, in a per curiam opinion, has ruled that the California Franchise Tax Board (FTB) did not violate a bankruptcy discharge order by attempting to collect the debtor's taxes, because the deficiencies were not assessed until after the debtor filed for bankruptcy.[91]

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[83] *In re Daniel*, 227 B.R. 675 98-1 U.S. Tax Cas. (CCH) ¶ 50,320, 81 A.F.T.R.2d (RIA) 1342 (Bankr. N.D. Ind. 1998).
[84] 965 F.2d 554 (7th Cir. 1992).
[85] 191 B.R. 869 (Bankr. D. Or. 1996).
[86] 141 B.R. 751; Bankr. L. Rep. (CCH) ¶ 74,520; 92-2 USTC (CCH) ¶ 50,330 (W.D. Okla. 1991), *aff'd* 994 F. 2d 763 (10th Cir. 1993).
[87] 70 B.R. 113 (Bankr. 9th Cir. 1986).
[88] 137 B.R. 671 (Bankr. N.D. Ohio 1992).
[89] 117 B.R. 541 (Bankr. D. Alaska 1990).
[90] Bacon and Billinger, *supra* note 1, at 77.
[91] *In re Bracey*, 77 F.3d 294 (9th Cir. 1996).

Under California law, a taxpayer has 60 days in which to file a protest against a notice of proposed assessment. If no protest is filed, the assessment becomes final at the expiration of the 60-day period. FTB sent the taxpayer a notice of proposed tax assessments for the years 1983 and 1984 on February 23, 1988. A letter of protest to the FTB was sent on April 21. The cover letter accompanying the protest referred to both tax years, but the protest itself referred only to 1984. The FTB received the protest on May 5, 1989. The taxpayer filed a chapter 7 petition and received a discharge. Subsequently, the FTB attempted to collect the 1983 and 1984 taxes, and the taxpayer filed a motion in the bankruptcy court to have the FTB held in contempt for attempting to collect the 1984 tax debt that was discharged.

The bankruptcy court denied the motion on the ground that the protest prevented the taxpayer's assessment from becoming final and thus the tax was not discharged. The Ninth Circuit Bankruptcy Appellate Panel reversed on the ground that the protest was not timely because the FTB did not receive it until after the 60-day period had expired. The FTB appealed. The Ninth Circuit determined that the FTB followed its internal procedures to conclude that the filing date of the protest was the date that appeared at the top of the protest letter. Because the protest was considered timely, the Ninth Circuit concluded that the assessment was not made until after the taxpayer filed for bankruptcy and that the taxes were not dischargeable.

The Ninth Circuit held in *Rhode v. United States*[92] that extensions not signed by the I.R.S. are ineffective. The *Rhode* decision was distinguished from *Holbrook v. United States*[93] and *Commissioner v. Hind.*[94]

In *Rhode,* the Ninth Circuit noted that Treas. Reg. section 301.6502(a)(2)(i) provided that the period of limitation may, prior to expiration, "be extended for any period of time agreed upon in writing by the taxpayer and the district director. The extension shall become effective upon execution of the agreement by both the taxpayer and the district director." The court noted that the language dealing with agreement had no counterpart in prior regulations and was not considered in *Holbrook* or *Hind.* The court, as noted later, also referred to the form as suggesting that an agreement existed. Section 6487 does not state that the agreement must be made between the representative of the SBE and the taxpayer, but it does refer to the "period agreed upon" and the form indicates that the SBE has accepted the item to which the taxpayer has agreed.

The district court held in *Howard v. United States*[95] that a tax under section 6672 of the Internal Revenue Code was not assessable because no one had signed a Form 2750 waiver on behalf of the Service, even though the taxpayer did sign the Form. A second extension on Form 2750 was signed by a representative of the IRS, but the court held that the second Form 2750 could not extend the limitations period because "section 6501(c)(4) of the Internal Revenue Code

[92] 415 F.2d 695 (9th Cir. 1969).
[93] 284 F.2d 747 (9th Cir. 1960).
[94] 52 F.2d 1075 (9th Cir. 1931).
[95] 868 F. Supp. 1197 (N.D. Cal. 1994).

requires subsequent extension agreements to be executed before the previously agreed upon period expires."

The bankruptcy court held in *In re Blake, Jr.*[96] that if a debtor executes a Form 872-A (an open-ended extension of the statute of limitations on assessment) and the Form is not terminated, any tax liability arising from the taxable periods covered by the extension will not be discharged, regardless of the age of the tax. In the case of a state tax, the assessibility of the tax will be determined by the applicable state law.[97]

A tax pending determination by the Tax Court at the date the petition is filed will be granted eighth priority. If the Tax Court has decided the issue against the taxpayer before a petition is filed and if no appeal is made, the tax will receive eighth priority even though no assessment has been made as of the petition date. The Bankruptcy Code ends the practice under prior law where once the case was resolved in Tax Court and the assessment restriction was removed, the taxpayer could file a petition before the IRS could make the assessment and thus would avoid the tax being considered as a priority claim. If, of course, the assessment is made before the petition is filed, the 240-day rule is in effect. Thus, tax claims due for petitions filed within 240 days after the assessment are eighth priority, and tax claims due where the petition is filed more than 240 days after would not receive priority unless the 3-year period discussed above applies.

A question has arisen as to the impact of a dismissed bankruptcy case on the provisions of section 507(a)(8)(A) of the Bankruptcy Code. Does one count the time that a petition was filed and subsequently dismissed? Section 108(c) of the Bankruptcy Code provides:

> Except as provided in section 524 of this title, if applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period for commencing or continuing a civil action in a court other than a bankruptcy court on a claim against the debtor, or against an individual with respect to which such individual is protected under section 1201 or 1301 of this title, and such period has not expired before the date of the filing of the petition, then such period does not expire until the later of—
>
> (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or
>
> (2) 30 days after notice of the termination or expiration of the stay under section 362, 722, 1201 or 1301 of this title, as the case may be, with respect to such claim.

Courts[98] have generally held that section 108(c) works to extend the time under section 507 of the Bankruptcy Code for the tax to be a priority item. The time that a debtor is in chapter 11 would not be counted. It would appear that

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[96] 154 B.R. 590 (Bankr. M.D. Ala. 1992).

[97] *In re Vitaliano*, 178 B.R. 205 (Bankr. 9th Cir. 1995).

[98] *In re Brickley*, 70 B.R. 113 (Bankr. 9th Cir. 1986); *In re Dietz*, 116 B.R. 792 (Bankr. D. Colo. 1990); *In re Molina*, 99 B.R. 792 (Bankr. S.D. Ohio); *In re Davidson*, 120 B.R. 777 (Bankr. D.N.J. 1990); *In re Florence*, 115 B.R. 109 (Bankr. S.D. Ohio 1990); *In re Quinlan*, 107 B.R. 300 (Bankr. Colo. 1989); *In re Ryan*, 1989 WL 155684 (Bankr. Colo. Dec. 15, 1989); *In re Carter*, 74 B.R. 613 (Bankr. E.D. Pa. 1987); *In re James Wise*, 127 B.R. 20 (Bankr. E.D. Ark. 1990).

this provision would apply to the three conditions (tax due within 3 years, due within 240 days after assessment is made, or still assessable) under which an income or gross receipts tax would be considered a priority item under section 507(a)(8)(A) of the Bankruptcy Code.

(ii) Property Taxes

Property taxes assessed and last payable without penalty within 1 year before the petition is filed are granted eighth priority. Note that the time period here is 1-year rather than the 3-year period that applies to income and gross receipts tax.

(iii) Withholding Taxes

Section 507(a)(8)(C) of the Bankruptcy Code gives eighth priority to all taxes that the debtor was required to withhold and collect from others for which the debtor is liable in whatever capacity. There is no time limit on the age of these taxes. Included in this category would be withheld income taxes, state sales taxes, excise taxes, and withholdings on interest and dividend payments. Taxes withheld on wages will receive eighth priority, provided the wages were paid before the petition was filed. If not, then they will have the same priority as the wage claims. The part of the wages granted third priority will result in the related withholding taxes (not employer's taxes) also being granted third priority. Taxes that relate to the wages that are classified as unsecured claims (i.e., excess over $4,925 for each employee or incurred more than 90 days before the petition was filed) will receive no priority. The eighth priority (or third, if wages have not been paid) on withholding taxes includes all taxes that have been withheld or will be withheld on wages earned prior to the petition date even though Form 941 has not been filed. Withholding taxes will be classified as an administrative expense only when they are withheld on wages earned after the petition is filed. Thus, it will often be necessary to classify part of the withholding taxes on the quarterly return as eighth priority and the other part as administrative expenses.

To properly determine the priority of withholding taxes, the financial or tax advisor must first determine when wages were paid (before or after petition date) for which withholdings were taken; if they were paid after the petition date, what is the priority of the wages? Withholding taxes on wages earned after the petition is filed are granted first priority.

Thus, withholding taxes can have first, third, eighth, or general creditor priority, depending on the status of the related payments. Note that the provisions discussed in this section refer only to the taxes withheld and not to the employer's share of FICA tax.

The employee is given credit for the tax even though the taxes are not actually remitted by the employer.[99] If Form 941 is past due at the time the bankruptcy petition is filed, the trustee or debtor-in-possession should file the return even though the prepetition withholding and employer's taxes cannot be paid until such payment is authorized by the court or provided for in the plan.

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[99] *Slodov v. United States*, 436 U.S. 238 (1978).

The Supreme Court, in *Harry P. Beiger, Jr.*,[100] ruled that taxes held in trust for a tax authority and remitted prior to the filing of the petition are not subject to recovery, but, in fact, are property of the government. If the taxes have not been remitted before the petition is filed, it would appear that the debtor could petition the court to allow payment to be made before other administrative expenses are paid, because the withholdings are not an asset of the estate but property of the taxing authority.

A Ninth Circuit case and a Ninth Circuit BAP case indicate that sales taxes from the state of Washngton are trust fund taxes.[101] However, as noted above, sales taxes in the state of California are not trust fund taxes, but were considered to be a gross receipts tax under section 507(a)(8)(A).[102]

The 20 percent backup withholding on compensation paid by an individual for the services of workers he knew lacked valid social security numbers and valid immigration status was allowed as a priority tax claim.[103]

The Eleventh Circuit, in a brief per curiam affirmance, held that an individual's liability for unpaid trust fund taxes was not discharged in bankruptcy. The Eleventh Circuit ruled that sections 507(a)(8)(C) and 523(a)(1)(A) of the Bankruptcy Code except from discharge a debt for a tax required to be collected or withheld and for which the debtor is liable in whatever capacity.[104]

In a chapter 13 case, the bankruptcy court held that a prepetition child support obligation assigned to the IRS under I.R.C. section 6305 is entitled to priority as if it were a tax under section 507(a)(8) of the Bankruptcy Code. The court noted that I.R.S. section 6305 states that the obligation is to be treated as if it were a tax under Subtitle C, and it may therefore be treated as if it were a tax under Bankruptcy Code sections 507(a)(8)(C) and (D).[105] Note this case was filed before the effective date of the Bankruptcy Reform Act of 1994. The Act provides, in section 507(a)(7) of the Bankruptcy Code as amended, that unpaid child support may be a priority item.

(iv) Employer's Taxes

An employment tax on wages, salary, or commission earned before the petition was filed receives eighth priority, provided the date the last return was due, including extensions, is within 3 years before the filing date. Taxes due beyond this date are considered general claims and are dischargeable. Note that this relates to the employer's share of the tax and not the taxes withheld. Thus, as with the withholding tax, it will be necessary to determine the wages that were earned prior to the petition date because employer's taxes on these wages have

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[100] 110 S. Ct. 2258 (1990).

[101] *Shank v. Washington Department of Revenue*, 792 F.2d 829 (9th Cir. 1986); *In re* George, 95 B.R. 718 (Bankr. 9th Cir. 1989), *aff'd, without opinion*, 905 F.2d 1540 (9th Cir. 1990).

[102] *In re Raiman*, 172 B.R. 933 (Bankr. 9th Cir. 1994).

[103] *In re Trypucko*, 1995 Bankr. LEXIS 2050 (Bankr. C.D. Cal. Oct. 19, 1995).

[104] *United States v. Kirkpatrick*, 89 F.3d 854, 78 A.F.T.R. 2d (RIA) 5161 (11th Cir. 1996).

[105] *In re Gillespie*, 1996 Bankr. LEXIS 704, 96-2 U.S. Tax Cas. (CCH) ¶ 50,409, 78 A.F.T.R.2d (P-H) 5236 (Bankr. D. Minn. 1996).

an eighth priority (see the following paragraph). Employer's taxes on wages earned after the petition is filed are administrative expenses—first priority.

Section 507(a)(8)(D) indicates that employment taxes on wages earned from the debtor before the filing of the petition are an eighth priority, "whether or not actually paid before such date." However, it would appear that this provision applies only to wages that are actually paid before the petition is filed. I.R.C. section 3111(a) and most, if not all, state laws provide that employment taxes arise only when the wages are paid.[106]

On wages not paid before the petition was filed, it was the intent of Congress to grant eighth priority only to the employer's share of the tax due on wages that receive third priority. The employer's tax on wages that are not granted priority would thus be a general claim, as would the wages. However, Section 507(a)(8)(D) of the Bankruptcy Code does not address the issue even though it was the intent of Congress.

A problem arises as to how to handle the quarterly tax returns that should be filed by the employer, such as Form 941. Representatives for the Special Services area of the IRS have suggested that the taxpayer file two tax returns in the quarter that the bankruptcy petition is filed: one for the period prior to the filing of the petition, and one for the period from the date the petition is filed to the end of the quarter. Those taxes reported on the quarterly return for the period prior to the filing of the petition would be prepetition taxes; those reported on the return for the balance of the quarter following the filing of the petition would be considered administrative expenses. This might help the IRS separate the prepetition taxes from the postpetition taxes, but it does not solve all of the identification problems. For example, if prepetition wages are paid several months (or even years) after the end of the quarter in which the petition was filed, the withholding taxes and employer's taxes are still prepetition taxes, even though they are listed on a subsequent quarterly tax return.

Section 507(a)(8)(D) of the Bankruptcy Code allows as a priority tax "an employment tax on a wage . . . of a kind specified in paragraph (3) of this subsection [priority wage] earned from the debtor before the date of the filing of the petition . . . for which a return is last due, under applicable law or under any extension, after three years before the date of the filing of the petition."

In *Eliawira Ndosi v. State of Minnesota*,[107] the Eighth Circuit looked at the meaning of the phrase "earned from the debtor." Eliawira and Barbara Ndosi were officers and controlling owners of Ndosi Enterprises, Inc., a Minnesota corporation. The company failed to pay to the state unemployment insurance contributions on wages paid to employees during 1988 and 1989. Under state law, Eliawira and Barbara Ndosi were notified that they were personally liable for

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[106] *In re Pierce*, 935 F.2d 709 (5th Cir. 1991). *See Bellus v. United States*, 125 F.3d 821, 823 (9th Cir., 1997) (by the reasoning of the Pacific-Atlantic court [see §,11.2(b)] , employment taxes are incurred when the payment of wages is made); *See also Marvel v. United States*, 719 F.2d 1507, 1514 (10th Cir. 1983) (liability for employment taxes arises by virtue of the statutory duties that are imposed on the employer to collect and pay over the taxes, no notice of deficiency or assessment need be given).

[107] 950 F.2d 1376 (8th Cir. 1991).

over $21,000 of unpaid insurance contributions. Three months later, Eliawira and Barbara Ndosi filed a chapter 7 bankruptcy petition and subsequently filed a complaint to determine the dischargeability of personal liability for the corporation's unemployment insurance obligations. The bankruptcy court held that the Ndosis' personal liability was dischargeable because it did not arise from wages "earned from the debtor" within the meaning of 11 U.S.C. section 507(a)(8)(D). The district court and the Eighth Circuit affirmed the decision of the bankruptcy court.

The Eighth Circuit noted that the language of section 507(a)(8)(C) of the Bankruptcy Code supports a strict interpretation of the phrase "from the debtor," finding that section 507(a)(8)(C) renders nondischargeable any debts for tax for which the debtor is liable in whatever capacity. According to the Eighth Circuit, Congress could have used similar language in section 507(a)(8)(D) but elected not to do so.

(v) Excise Taxes

For an excise tax to qualify as a tax priority, the transaction creating the tax must have occurred before the petition was filed. In addition, if the excise tax is of the type that requires a tax return, it may receive eighth priority if the day the return is last due (including extensions) is within 3 years before the petition was filed. If no return is required, the 3-year limitation begins on the date the transaction occurred[108] (Bankruptcy Code section 507(a)(8)(E)). This group of taxes includes sales taxes, use taxes, estate and gift taxes, gasoline taxes, and other federal, state, or local taxes defined by statute as excise taxes.

Considerable conflict exists as to whether the penalty imposed under section 4971(a) is an excise tax under section 507(a)(8)(E) of the Bankruptcy Code or a penalty. In *United States v. Reorganized CF&I Fabricators of Utah, Inc.*,[109] the Supreme Court held that the funding-deficiency tax in section 4971(a) is not an excise tax for priority purposes under 11 U.S.C. section 507(a)(8)(E). The Court concluded that Congress had created not an excise tax but a penalty—an exaction imposed by statute as punishment for an unlawful act. The Court noted both the absence from section 4971 of the word *excise* and the established principle that characterizations in the Internal Revenue Code are not dispositive in the bankruptcy context. Thus, because of the punitive function of the section 4971 exaction, the Court held that the Service's claim was not entitled to priority under section 507(a)(8) of the Bankruptcy Code. The claim would not be a priority under section 507(a)(8)(G) because the penalty was not for actual pecuniary loss. The claim would be an unsecured claim and not subject to equitable subordination.

The bankruptcy court recommended that the district court grant a debtor a refund of interest paid on a section 4975 assessment for prohibited transactions involving an ESOP, because the section 4975 excise tax is a penalty.[110] Thus,

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[108] 11 U.S.C. § 507(a)(8)(E).

[109] 116 S. Ct. 2106 (1996).

[110] *MMR Corp. v. United States*, 1998 Bankr. LEXIS 1132; 82 A.F.T.R.2d (RIA) 6099 (Bankr. M.D. La. 1998).

interest begins to accrue 10 days after the IRS issues notice and demand, not as of the tax periods for which the penalties are assessed. Section 4975(a) is indistinguishable from section 4971 in its purpose, legislative history, and structured levels of sanctions. The bankruptcy court noted that it is the nature of the transaction that determines the assessment, in each statute, and it is clear that both statutes exist to punish the parties initiating the transaction.

The Circuit Courts do not agree on whether an excise tax under I.R.C. section 4971 is a priority tax or a penalty. In *In re Mansfield Tire & Rubber Co.,*[111] the excise tax was held to be a priority item. Mansfield asked the Supreme Court to hear the case; certiorari was denied in February 1992.

In 1979, debtors Mansfield Tire and Rubber Company, Pennsylvania Tire and Rubber Company of Mississippi, Inc., and Pennsylvania Tire Company filed petitions for relief under chapter 11 of the Bankruptcy Code. The United States filed a proof of claim asserting, *inter alia,* unsecured claims in the amount of $363,111.20 for the debtors' pension excise tax liability under I.R.C. section 4971(a). The government contended that the excise tax liabilities are entitled to distributive priority under section 507(a)(8) of the Bankruptcy Code.

The trustees objected to the pension excise tax proof of claim, asserting that the claim is not entitled to priority because it constitutes a penalty rather than a tax, and that it should therefore be subordinated to the claims of general unsecured creditors pursuant to either sections 726(a)(4) or 510(c) of the Bankruptcy Code.

The Bankruptcy Court determined that the IRS's section 4971 claim was not eligible for priority under section 507(a)(8)(E) of the Bankruptcy Code and that the claim should be subordinated in distribution to the claims of general unsecured creditors pursuant to section 510(c) of the Bankruptcy Code. The District Court affirmed, agreeing that excise taxes under I.R.C. section 4971(a) are penalties rather than excise taxes for purposes of the Bankruptcy Code, and thus are not entitled to the priority granted to excise taxes by section 507(a)(8)(E) of the Bankruptcy Code. The district court also noted that because the claims are characterized as penalties, it was proper for the bankruptcy court to equitably subordinate those claims to those of general unsecured creditors pursuant to section 510(c) of the Bankruptcy Code.

The Sixth Circuit looked at two questions:

1. Whether a federal excise tax imposed by I.R.C. section 4971(a) is an "excise tax" entitled to priority under section 507(a)(8)(E) of the Bankruptcy Code;
2. Whether a tax owed to the federal government may be equitably subordinated to other claims only upon a showing of inequitable conduct by the federal government. (The subordination of tax claims is described in subsequent § 11.2(g).)

[111] 942 F.2d 1055 (6th Cir. 1991).

The challenged claims stem from assessments made under I.R.C. section 4971(a) and resulting from the debtors' failure to meet minimum funding requirements for a pension plan. I.R.C. section 4971 was enacted as part of ERISA in 1974 as a means of enforcing the minimum funding requirements of ERISA. I.R.C. section 4971 provides, in relevant part:

> (A) Initial tax—For each taxable year of an employer who maintains a plan to which section 412 applies, there is hereby imposed a tax of 10 percent . . . on the amount of the accumulated funding deficiency under the plan, determined as of the end of the plan year ending with or within such taxable year.
>
> * * *
>
> (e) LIABILITY FOR TAX.—
>
> (1) IN GENERAL— . . . the tax imposed by subsection (a) or (b) shall be paid by the employer responsible for contributing to or under the plan the amount described in section 412(b)(3)(A).

Section 507(a)(8)(E) of the Bankruptcy Code provides that an excise tax (1) on transactions occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after 3 years before the date of filing of the petition or (2) if a return is not required, on transactions occurring during the 3 years immediately preceding the date of the filing of the petition, is a priority tax.

The government argued that because I.R.C. section 4971 assessments are excise taxes, they are entitled to priority under section 507(a)(8)(E) of the Bankruptcy Code. The trustees argued that such assessments are actually penalties disguised as taxes and thus should not be given priority under section 507(a)(8)(E). Further, the trustees argued that the I.R.C. section 4971 assessments are nonpecuniary loss penalties, which should be subordinated to the claims of general unsecured creditors.

The Sixth Circuit noted that the Bankruptcy Code does not define "tax" or "excise tax" and therefore we are not persuaded that Congress intended to give a special bankruptcy-context meaning to those words. The court further stated: "We see no indication, either in the statute itself or in the legislative history underlying that provision, that Congress intended to deny priority to any federal excise tax."

The trustees argued that prioritizing the government's section 4971 claims "would afford them a distributive advantage not envisioned by the drafters of the Bankruptcy Code—an advantage whose ultimate cost would be borne by Mansfield's innocent creditors." The court responded by stating that "[a]lthough the Bankruptcy Code does not define 'tax' or 'excise tax' it seems to us that when Congress said 'excise tax' in section 507(a)(8)(E), Congress at the very least meant to include those exactions which Congress itself had previously deemed to be federal excise taxes."

The Sixth Circuit refused to allow a federal tax that is called an excise tax to be classified any other way by the bankruptcy courts. The cases that were used by other courts to hold that the bankruptcy court can examine the nature of the

tax were not federal tax claims. The court stated, "We do not hold that any exaction deemed an excise tax by a body other than Congress is entitled to the same deference. In cases of state and local exactions it may be appropriate to more closely examine the particular governmental claim to determine whether it truly is in the nature of a 'tax' as that term is used by Congress."

The trustees relied on *City of New York v. Feiring,*[112] *In re Kline,*[113] and *In re Unified Control Systems, Inc.*[114] The Fourth and Fifth Circuits held that excise taxes under 11 U.S.C. section 4941 were really penalties for purposes of determining their eligibility for priority distribution under the Bankruptcy Act. The Sixth Circuit, in *Mansfield,* noted that those cases were wrongly decided to the extent that they held that the federal courts should look beyond the characterization of Congress to determine whether an exaction is a "tax" entitled to priority under federal bankruptcy law.

The District Court in *Kline* held that the name given to the exaction by the legislature is not conclusive, citing *New Jersey v. Anderson,* where the Supreme Court held that the purpose of the particular enactment is the controlling factor. An enactment which has as its purpose the punishment of conduct perceived to be wrongful should be deemed a "penalty" regardless of the terminology employed by the legislature.[115]

The Court in *Mansfield* noted that reliance on *Anderson* and other Supreme Court decisions for the issue before us is based on misreading the holdings of those cases. *Anderson,* according to Sixth Circuit, concerned whether a New Jersey franchise tax was entitled to preferential treatment under section 64a of the Bankruptcy Act, which provided priority for "all taxes legally due and owing by the bankrupt to the United States, state, county, etc. . . ." The court held that whether a debt is a "tax" within the Bankruptcy Act cannot be controlled by the label applied by a nonfederal governmental unit. The reasoning in *Anderson* was tied to the fact that a state-defined "tax" was at issue.

Unfortunately, the *Kline* court and others have cut loose the *Anderson* holding from its moorings by reading the *Anderson* decision as giving license to question every debt which is labelled a "tax," even where the "tax" designation has been made by Congress. Similarly, in none of the other Supreme Court cases relied upon by the *Kline* court[116] did the Court indicate that Congress' characterization of the federal exaction as a "tax" is not conclusive for purposes of bankruptcy.

The Sixth Circuit noted that the Fifth Circuit, in *Unified Control,* did not purport to rely on any cases concerning taxes and bankruptcy priorities for its conclusion that "the label placed upon an imposition in a revenue measure is not

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[112] 313 U.S. 283 (1941).

[113] 403 F. Supp. 974 (D. Md. 1975), *aff'd,* 547 F.2d 823 (4th Cir. 1977).

[114] 586 F.2d 1036 (5th Cir. 1978).

[115] Kline, *supra* note 117, 403 F. Supp. at 978.

[116] *See* Simonson, 369 U.S. 38 (1962); *United States v. New York*, 315 U.S. 510 (1962); *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564 (1942); *United States v. Childs*, 266 U.S. 304 (1924); *New York v. Jersawit*, 263 U.S. 493 (1923).

decisive in determining its character."[117] However, the court did discuss the broad congressional policy against allowing priority for penalties because of the resulting punishment of innocent creditors, quoting at length from the Supreme Court's decision in *Simonson*,[118] a case also relied on by the trustees here. We find reliance on *Simonson* misplaced in this context; the Supreme Court was interpreting section 57j of the Bankruptcy Act, which held that "debts owing to the United States . . . as a penalty or forfeiture shall not be allowed." It was undisputed in that case that the claims at issue were characterized as "penalties" by Congress. The Court, in an opinion of less than three full pages, simply applied the plain reading of 57j to the congressional characterization of the claims to find that the asserted claims were not allowed.[119]

The Sixth Circuit then noted that *Simonson* does not support the proposition that the courts should or may disregard a congressional characterization of a payment of a tax when a court believes that it is actually a penalty.

The trustees also argued that, in *In re Jenny Lynn Mining Co.*[120] and *United States v. River Coal Co.*,[121] the Sixth Circuit looked beyond the characterization of certain payments to determine whether the payments were "taxes" for purposes of bankruptcy law. The Sixth Circuit stated: "[N]either *Jenny Lynn Mining* nor *River Coal* concerned the issue presented in this case, nor do those cases suggest that we should independently decide whether that which Congress has designated a 'tax' is a 'tax' for bankruptcy purposes."

Excise taxes imposed on termination of a qualified pension plan are a priority tax. In *In re C-T of Virginia, Inc.*,[122] the IRS imposed a tax under I.R.C. section 4980 for a reversion of assets following the termination of its qualified pension plan. C-T of Virginia filed a bankruptcy petition and the unsecured creditors' committee argued on behalf of the debtor that the I.R.C. section 4980 tax is a penalty that is not entitled to priority under section 507(a)(8)(E) of the Bankruptcy Code. The government, on the other hand, argued that the tax is an excise tax and, thus, is entitled to priority.

The bankruptcy court, in holding that the claim is not entitled to priority, noted that there were no prior court decisions on whether the I.R.C. section 4980 tax was intended for the purpose of raising revenue or any other public purpose. The court determined that legislative history suggests that the tax was intended to discourage employers from terminating overfunded retirement plans and using the excess funds for nonretirement purposes. Thus, according to the court the tax is not a pecuniary loss penalty because it is imposed whether or not there has been any loss to the government.

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[117] 586 F.2d at 1037.
[118] *Supra* note 120, 369 U.S 38. at 40.
[119] *Id.*
[120] 780 F.2d 585 (6th Cir.), *cert. denied*, 477 U.S. 905 (1986).
[121] 748 F.2d 1103 (6th Cir. 1984).
[122] 128 B.R. 628 (Bankr. Ct. W.D. Va. 1991).

However, on appeal, the district court[123] held that the I.R.C. section 4980 tax had more indicia of an excise tax than a penalty.

A bankruptcy court ruled that premiums payable to the West Virginia Workers' Compensation Fund are not excise taxes under section 507(a)(8)(E) of the Bankruptcy Code and are thus not entitled to priority. A District Court reversed by ruling that the premiums are excise taxes. The debtor, New Neighborhoods, Inc., appealed, arguing that the West Virginia fund was more akin to insurance and as such should not be accorded a priority claim.

The Fourth Circuit[124] held that the premiums are excise taxes entitled to priority in bankruptcy. The Fourth Circuit court indicated that the premiums employers must pay under the workers' compensation law are burdens imposed for a public, governmental purpose, which is to allocate the burden of the costs of injured employees and their dependents among employers, rather than among the general public. The Fourth Circuit court ruled that the single-purpose nature of the workers' compensation premiums did not render them something other than taxes.

The Ninth Circuit held that a prepetition obligation owed to the State of California for payments paid to injured employees because the debtor did not provide workers' compensation insurance is not an excise tax. The Ninth Circuit noted that the claim was not an excise tax, regardless of the language used to describe the obligation. State terminology does not control the dischargeability of a debt.[125] The First Circuit concluded that a prepetition claim for an assessment against a debtor hospital was an excise. State law requires that certain hospitals participate in a pool that funds care to indigent and unsecured patients. The unpaid prepetition assessments against a debtor hospital were classified as an excess tax with priority under section 507(a)(8)(E). The First Circuit followed the process developed by *In re Lorber Indus. of California*[126] and *In re Suburban Motor Freight*[127] by answering a group of question to arrive at the decision that the claims were or were not tax claims.

(vi) Customs Duties

Section 507(a)(8)(F) of the Bankruptcy Code provides that a customs duty arising from the importation of merchandise will receive priority if (1) entered for consumption within 1 year before the bankruptcy petition is filed, (2) covered by an entry liquidated or reliquidated within 1 year before the date the petition was filed, or (3) entered for consumption within 4 years before the petition date, but not liquidated by that date, if the Secretary of the Treasury certifies that the duties were not liquidated due to an investigation into assessment of antidump-

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[123] 135 B.R. 501 (W.D. Va. 1991), *aff'd*, 977 F.2d 137 (4th Cir. 1992).

[124] *New Neighborhoods, Inc. v. West Virginia Workers' Compensation Fund*, 886 F.2d 714 (4th Cir. 1989).

[125] *In re George*, 361 F. 3d 1157 (9th Cir. 2004).

[126] 675 F 2d 1062 (9th Cir. 1982).

[127] 36 F.3d 484 (6th Cir. 1994).

ing or countervailing duties, fraud, or lack of information to properly appraise or classify such merchandise.

(f) 100 Percent (Withholding Tax) Penalty

Businesses that are in financial trouble often delay paying employment taxes. Their intent is to submit the payments as soon as conditions improve. The problem is that conditions do not improve. Additional pressures are placed on the debtor by major creditors demanding payment. Again, the taxes withheld are not remitted. At the time the business files a bankruptcy petition, the unpaid tax withholdings are significant. At this stage, corporate officers often find out that they can be personally liable for their taxes. I.R.C. section 6672 provides:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.

The amount of the penalty is equal to 100 percent of the tax that should have been withheld and remitted to the IRS. For example, in the case of employment taxes, it includes the income taxes and the employee's share of social security taxes withheld. Any interest and penalties associated with these taxes are not subject to the 100 percent provision. Note that the penalty does not mean that the taxes are paid twice, but that the liability for these taxes may be transferred to responsible persons of the corporation. IRS Policy Statement P-5-60 states:

> The 100-percent penalty (applicable to withheld employment taxes or collected excise taxes) will be used only as a collection device. If a corporation has willfully failed to collect or pay over employment taxes, or has willfully failed to pay over collected excise taxes, the 100-percent penalty will be asserted against responsible officers and employees of the corporation only if such taxes cannot be collected from the corporation itself. . . . When the person responsible for withholding, collecting and paying over taxes cannot otherwise be determined, the Service will look to the President, Secretary and the Treasurer of the Corporation as responsible officers.

If the responsible person subsequently files a bankruptcy petition, the I.R.C. section 6672 penalty is a priority tax claim and is not dischargeable.

For example, in *Robert Allen Garrett v. Commissioner*,[128] the taxpayer filed a chapter 7 petition in January 1988 and was granted a discharge 5 months later. He filed an adversary proceeding in the bankruptcy court, asserting that a 100 percent penalty under I.R.C. section 6672 was discharged in bankruptcy under section 523(a)(7) of the Bankruptcy Code, which allows for the discharge of tax penalties.

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[128] 126 B.R. 486 (Bankr. E.D. Va. 1991).

The court, citing *United States v. Sotelo,*[129] held that the I.R.C. section 6672 penalty is nondischargeable.

In *In re Smith,*[130] Leonard Smith's employer failed to pay over income and FICA taxes, and the IRS assessed penalties against Smith, under I.R.C. section 6672. Smith filed a chapter 7 bankruptcy petition and asked the court to determine the liability amount and dischargeability of the debt.

The bankruptcy court dismissed the complaint without prejudice, explaining that I.R.C. section 6672 taxes are not dischargeable in bankruptcy pursuant to *United States v. Sotelo*[131] and *Smith v. United States.*[132]

In *In re Dewberry,*[133] Dewberry filed a complaint in district court when an I.R.C. section 6672 assessment was converted to the bankruptcy court after Dewberry filed a bankruptcy petition. Dewberry argued that proper notice and demand had not been sent, that the assessment was made outside the statute of limitations, and that the IRS did not follow its own internal procedural requirements.

The court, noting the government's admission that notice and demand had not been sent to Dewberry's last known address and that proper notice and demand probably had not been made until January 1990, granted Dewberry's motion insofar as it requested a partial abatement of interest.

The court found that the assessment, made in September 1986, was timely and that the IRS's internal procedural requirements are directory rather than mandatory. Thus, the IRS's failure to follow them did not require an abatement of the assessment.

In *In re Robinson,*[134] the bankruptcy court refused to remove the stay and allow the IRS to file against Robinson and another individual a complaint resulting from the 100 percent penalty under section 6672 of the Bankruptcy Code. The bankruptcy court concluded that it would be unfair to Robinson and his creditors to require Robinson to go through the delay and extra expense of additional litigation that would result if the stay was removed.

The Supreme Court denied certiorari in an Eighth Circuit case. The Eighth Circuit, reversing a district court, held that the assessment of a section 6672 penalty against a bankrupt taxpayer was not voided by the IRS's issuance of a notice of proposed assessment that violated the automatic stay.[135]

The bankruptcy court held that the IRS's claim for a section 6672 penalty is entitled to secured status in a chapter 13 case because under sections 523(a)(1)(A) and 507(a)(8)(C) of the Bankruptcy Code the penalty was excepted from discharge in the debtor's prior, no-asset chapter 7 case.[136] The taxpayer argued that because the tax lien was securing only exempt property, it was discharged in the chapter 7 case. The bankruptcy court noted that the debt survived

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[129] 436 U.S. 268 (1978), *reh'g denied*, 438 U.S. 907 (1978).
[130] 1993 Bankr. LEXIS 1667 (Bankr. N.D. Ga. 1993).
[131] 436 U.S. 268 (1978).
[132] 894 F.2d 1549 (11th Cir. 1990).
[133] 158 B.R. 979 (Bankr. W.D. Mich. 1993).
[134] 1993 Bankr. LEXIS 1792 (Bankr. E.D. Va. 1993).
[135] *Riley v. United States*, 118 F.3d 1220 (8th Cir. 1997), *cert. denied,* 523 U.S. 1020 (1998).
[136] *In re Gust*, 239 B.R. 630 (S.D. Ga. 1999) *aff'd*. 197 F.3d 1112 (11th Cir. 1999).

the discharge because a section 6672 penalty is the kind of tax debt required to be collected or withheld and for which the debtor is liable under section 507(a)(8)(C).

(i) Responsible Person

Westfall[137] identified two elements that must be established before the IRS will assert the 100 percent penalty: responsibility and willfulness. He stated:

> [A] Responsible person is defined as one who had the duty to perform or the power to direct the act of collecting, accounting for and paying over the taxes. The responsible person may be an officer or employee of the corporation, a member or employee of a partnership, a corporate director or shareholder, or another person with sufficient control over funds to direct their disbursement. In some situations, responsible persons are not directly affiliated with the delinquent business. For example, if a bank or other financial institution furnishes funds to a business and directs how these funds are to be distributed, the IRS may find the bank liable for the penalty since it directed that the business not pay over the employment taxes.[138]

Normally, the IRS makes every effort to determine the individual or individuals who were obligated to see that the taxes were withheld, collected, and paid over to the government. The Appellate Court for the Federal Circuit held in *Godfrey*[139] that an outside director who did not have signatory authority over corporate accounts and who did not participate in the day-to-day fiscal management of a corporation was not personally responsible for the withholding of taxes. The Appellate Court held that even though Godfrey was elected chairman of the board of a financially troubled corporation and actively attempted to negotiate a recapitalization arrangement, he took no part in the decisions regarding the payment or deferral of corporate debt or the preparation of withholding statements. The court stated that the test as to whether an individual is responsible for the taxes hinges on whether the person has the power to control the disbursement of corporate funds on a daily basis.

The responsible person can be an outsider or even another corporation.[140] In *Robert F. Bentley*,[141] the court held that the secretary and legal counsel of Permalloy Corporation was not personally liable for withholding taxes even though he had twice negotiated with the IRS to achieve a payment plan for past due taxes. The court found that the corporation's president and chairman of the board had control over the corporate checking account and judgment for unpaid taxes had already been obtained against these two individuals.

In *Garland R. Pomeroy*,[142] the court awarded attorney's fees and costs because the government's position against the bookkeeper (imposition of a 100 percent penalty for failure to pay withholding taxes) was unreasonable. The court found

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[137] Westfall, Employment Taxes and the 100% Penalty, 14 TAX ADVISER 300, 301 (1983).

[138] *Id.*

[139] D. Godfrey Jr., 748 F.2d 1568 (1984), 84-2 USTC (CCH) ¶ 9974, *rev'g in part and vac'g in part*, 3 Cl. Ct. 595 (1983), 83-2 USTC (CCCH) ¶ 9635.

[140] *See Slodov v. Commissioner*, 436 U.S. 238 (1978).

[141] *Robert F. Bentley*, No. CIU 84-2348 PHX EHC; LEXIS, 86 TNT 167-34 (D.C. Ariz. 1986).

[142] 87-1 USTC (CCH) ¶ 9329 (D.C.W. Va. 1987).

that the bookkeeper had no discretionary authority in determining which creditors, if any, were to be paid prior to paying the withholding taxes. The authority to write checks alone is insufficient to make a reasonable case for imposing the penalty.

A bankruptcy court held that a partner is liable for the withholding taxes of a partnership whether or not the partner is a responsible person under I.R.C. section 6672.[143] An accounting firm may be held liable for trust fund taxes under I.R.C. section 6672. The United Dairy Farmers Cooperative Association hired Quattrone Accountants, Inc., to provide professional accounting services, including figuring the payrolls and paying bills. Not only did the firm use a facsimile stamp to sign checks for the cooperative, but it usually decided which bills to pay and which to defer. During 1980, the cooperative ran into problems and the cooperative's bank called an $800,000 loan. The cooperative then fell $50,000 behind on its withholding tax payments.

The bankruptcy court determined that Quattrone Accountants was a responsible person under I.R.C. section 6672, because it had the power to make the tax payments and chose to pay other creditors. The District Court upheld the bankruptcy court's decision.[144]

In *In re Bewley*,[145] the bankruptcy court ruled that the new president whose prior duty was only in sales was liable only to the extent of the $8,662 cash on hand when he assumed control of the corporation. The court applied the rationale of *Slodov v. United States*[146] to excuse a new chief operating officer from liability for most of the trust fund taxes accrued before his assumption of operating control.

In *Edward D. Goodick v. United States*,[147] the district court held that Edward Goodick was not a responsible person within the meaning of I.R.C. section 6672. In his capacity as district manager of several stores, Edward Goodick was in charge of hiring and firing personnel, controlling store operations, and evaluating the financial positions of the individual stores. However, he was in no way involved in the financial operations of the corporation as a whole. His father had the ultimate authority to make disbursements and oversee the payroll. While Edward Goodick was a signatory on the corporation's checking account, he only signed checks in emergencies and had no knowledge regarding the corporation's withholding tax liabilities. Edward Goodick was completely accountable to his father, who was domineering and controlled all of his son's activities within the company, including the amount of stock that Edward owned in the corporation.

In *In re Ross*,[148] the district court determined that the cook was responsible for the unpaid payroll taxes of a restaurant. Irene Ross was married to a man

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[143] *James Lee McManis*, 70 B.R. 171 (Bankr. E.D. Ky. 1986).

[144] *In re Quattrone Accountants Inc.*, 100 B.R. 235 (W.D. Pa. 1989), *aff'd*, 895 F.2d 921 (3rd Cir. 1990).

[145] 191 B.R 459 (Bankr. N.D. Okla. 1996); aff'd. 212 B.R. 668 (N.D. Okla. 1997).

[146] 436 U.S. 238 (1978).

[147] 1992 U.S. Dist. LEXIS 2956; 92-1 USTC (CCH) ¶ 50,279 (E.D. La. 1992).

[148] 173 B.R. 937 (Bankr. E.D. Wash. 1994).

who owned a restaurant business in the state of Washington, and she helped him by cooking, handling orders, waitressing, and doing other general work. She stopped working in the restaurant in July 1987 and she and her husband divorced in March 1989. Ross filed a bankruptcy petition in 1991 and the IRS filed a proof of claim for unpaid payroll taxes from the restaurant based on Washington's community property law.

The bankruptcy court concluded that (1) the business assets were community assets; (2) the business was a community business; (3) the business liabilities were community liabilities; and (4) Ross and her ex-husband had a partnership relationship. The bankruptcy court noted that Ross had a separate liability for the restaurant's payroll taxes because, under Washington law, as an active participant in the community business, she had a separate duty to assure that the payroll taxes were paid, even though she did not exercise her management rights. The district court also reaffirmed the finding of the lower court that Ross had a partnership relationship with her ex-husband.

The bankruptcy court held that a corporate vice-president was not a responsible person under section 6672 because he did not possess actual authority over company finances, even though he signed tax returns and was a signatory on the company's bank account.[149] The bank account required two signatures.

The bankruptcy court found that the vice-president possessed no actual control over Tri-D's financial affairs and had no power to direct the payment of particular creditors' claims. The court noted that DeMarco had trivial status, limited duties, and little actual authority. The court further cited evidence showing that the company secretary and wife of Tri-D's founder exercised total and exclusive dominance over Tri-D's financial affairs, including deciding which creditors were paid and approving all funds disbursement.

The Seventh Circuit has held that the state of Illinois had a valid claim for a responsible-person penalty against the bankrupt president of a now-defunct corporation that failed to pay use tax on its purchase of an airplane for over $12 million that it brought into the state.[150] The company—Chandler—never paid Illinois use tax, filed a use tax return, or registered the plane. By the time the state tax authority discovered the company owed use taxes, the corporation was defunct and the president was in bankruptcy.

The bankruptcy court held that Chandler owed use tax on the plane but that the taxpayer was not liable for the tax because the state's claim was barred by the Tax Injunction Act (TIA), 28 U.S.C. section 1341. Reversing, the Seventh Circuit held that the TIA did not apply because the Bankruptcy Code expressly authorizes bankruptcy courts to decide tax issues and because the TIA applies only to requests for injunctive remedies. On the merits, the appeals court rejected the trustee's contention that the purchase triggered no use tax liability, refusing to focus only on the transfer of title from PLI—a subsidiary or the seller—to Chandler. The Seventh Circuit stated that the "fact that title passed

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[149] *In re Lou DeMarco Jr.*, 1999 Bankr. LEXIS 29 (Bankr. M.D. Fla. 1999).

[150] *In re Stoecker*, 179 F.3d 546, 1999 U.S. App. LEXIS 11227; Bankr. L. Rep. (CCH) P77,934 (7th Cir. 1999).

from the retailer to its affiliate before coming to rest with Chandler did not make PLI the real seller," relying on the "substance over form" doctrine.

The First Circuit held that the president of a corporation is not personally liable under Massachusetts state law for unpaid state corporate taxes, because exclusive authority for tax payments was given to the treasurer of the corporation.[151] The corporate treasurer had exclusive responsibility for payment of corporate taxes and other legal and financial matters, while the president was responsible for day-to-day restaurant management.

The treasurer failed to pay corporate taxes, and Massachusetts filed a claim in the president's bankruptcy estate for unpaid corporate taxes. Both the bankruptcy court and the district court held that the president was not liable for the taxes. Massachusetts appealed to the First Circuit.

The First Circuit agreed that the president did not have a duty to pay taxes under Massachusetts' law. Among other factors that helped the court decide in favor of the taxpayer was the fact that the friends had a binding oral agreement regarding division of responsibility and their actual practice adhering to the agreement.

While the court rejected Massachusetts' argument that the federal responsible-person standard governed the issue of the president's duty to remit taxes because federal cases provide only secondary persuasive authority for Massachusetts courts, the First Circuit noted that it would have reached the same conclusion had federal case law been relied on.

In M*ercantile Bank v. United States,*[152] the district court noted that for a third-party lender to qualify as a person under section 6672, the lender must have the power to see to it that the taxes are paid. The court added that the lender must assume control over how the employer's funds are spent and over the process of deciding which creditors of the employer are paid and when. The court then rejected the IRS's contention that the terms of the loan and security agreement were sufficient to make the bank a *person* for purposes of section 6672. The court distinguished this decision from *Commonwealth National Bank v. United States,*[153] on the basis that the third-party lender in Commonwealth required the third-party lender to actually exercise control over the employer's funds whereas in this case, the bank had the power to control. The court held that the mere existence of the power to control is insufficient and that the bank, in deciding which checks not to pay had simply applied its normal check return policy and did not exercise its power under the loan agreement to control the debtor's business.

The district court determined that Goodick was merely an employee of the company who had no authority to see that the tax liability was paid. The court noted that Edward Goodick was so controlled by his father that he exercised no significant independent authority in the company and did not participate in making major decisions as to how the corporation would operate.

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[151] *Adams v. Coveney*, 162 F.3d 23 (1st Cir. 1998).
[152] 856 F. Supp. 1355 (W.D. Mo. 1994).
[153] 665 F.2d 743 (5th Cir. 1982).

In *In re Dennis L. Chambers,* [154] the district court also held that the IRS is liable for attorney's fees in a case where action to collect the 100 percent penalty from the taxpayer whom the IRS claimed was the responsible person was not justified. The district court concluded that the bankruptcy court properly determined that the government's position was not substantially justified.

The Fourth Circuit has held that a receiver, appointed prior to the effective date of the Bankruptcy Code, is liable for unpaid prepetition employment taxes, income taxes of the bankrupt and postpetition employment taxes. The receiver was held to be personally liable for these taxes under the insolvency statutes.[155]

The responsible person is also liable for unpaid interest on the tax assessment due to a failure of the debtor to remit withholdings to the IRS under I.R.C. section 6672. The responsible person claimed in *Jack Turchon*[156] that he was not liable for the unpaid interest because there was no liability running for the employer. The court noted that the liability under I.R.C. section 6672 is separate and distinct from that imposed on an employer.

In general, courts have taken a broad view of who constitutes a responsible person. As a result, liability for the penalty is not confined to disbursing officers or officers with authority to draw or sign checks.[157] In *Thibodeau v. United States,*[158] the Eleventh Circuit held that the taxpayer was a responsible person as a matter of law because he was the president, a director, and the resident agent of the employer during the relevant tax periods and because he was responsible for running the office, securing contracts, arranging financing, and conducting some hiring and firing.[159]

(A) Willfully

Willfully is defined as meaning, in general, a voluntary, conscious, and intentional act. The willfulness requirement of I.R.C. section 6672 is generally satisfied if there is evidence that the responsible person had knowledge of payments to other creditors after the person was aware of the failure to remit withholding taxes. It is not necessary to have evidence that a withholding tax return should have been filed at the time when the responsible officer knew that other creditors were being paid. Liability under I.R.C. section 6672 can arise from a misuse of withheld funds before the date when the corporation is required to pay over the funds.[160]

Once it is established that a person is responsible for the withholding tax, courts have generally taken the position that the responsible person has the burden of disproving willfulness.[161] For example, in *Smith v. United States,*[162] the Eleventh Circuit held that Smith had the burden of disproving willfulness.

[154] 140 B.R. 233 (Bankr. N.D. Ill. 1992).
[155] *United States v. The American Insurance Co*. 852 F.2d 566 (4th Cir. 1988).
[156] 87-2 USTC (CCH) ¶ 9541 (E.D.N.Y. 1987), *aff'd*, 841 F.2d 1116 (2nd Cir. 1988).
[157] *Liddon v. United States*, 448 F.2d 509, 512 (5th Cir. 1971).
[158] 828 F.2d 1499 (11th Cir. 1987).
[159] *ld.* at 1504
[160] *Newsome v. United States*, 431 F.2d 742, 745-46 (5th Cir. 1970).
[161] *Thibodeau , supra* note 162 at 1505.
[162] 894 F.2d 1549 (11th Cir. 1990).

The Eleventh Circuit then noted that Smith had to prove that he did not pay any creditors after he became aware of the withholding tax problem. Smith testified that employees were paid every Friday until the bankruptcy filing. Thus, Smith had to prove that he did not know of the payroll tax problem until after the bankruptcy filing. However, Smith testified that he became aware of the company's failure to remit its payroll deductions several weeks before the petition was filed.

The *Thibodeau* court stated that the willfulness requirement is also met if the responsible officer shows a reckless disregard of a known or obvious risk that trust funds may not be remitted to the government.[163] In *Smith,* the court held that Smith recklessly disregarded an obvious risk that the government would not receive the withholding taxes to which it was entitled when he refused to listen to another employee's pleas that Smith look into the company's financial problems. The court noted that a responsible person cannot avoid liability by showing that he closed his eyes to the company's problems. Accordingly, the court concluded that Smith also was willful because he disregarded the risks brought to his attention by another employee.[164]

Courts have generally not accepted the argument that if a company has sufficient funds on hand to meet its withholding tax obligations, willfulness has been disproved. In *Thibodeau,* the court held that the failure to segregate withholdings from other corporate assets is an indication of willfulness.[165] The *Thibodeau* court also held it irrelevant that the corporation declared bankruptcy before the taxes were actually due.

In *In re Vaglica,*[166] the Fifth Circuit held that Charles Vaglica acted willfully under I.R.C. section 6672 and was responsible for unpaid withholding taxes. Vaglica filed a bankruptcy petition and the IRS filed a proof of claim for the 100 percent penalty under I.R.C. section 6672 against Vaglica for unpaid withholding taxes owed by Vaglica's wholly owned corporation. The company received several delinquency notices, but elected to pay creditors instead of paying the withholding taxes to the IRS. Vaglica objected to the IRS's claim on the basis that he did not willfully avoid paying withholding taxes. The bankruptcy court overruled his objection, and the district court affirmed. Willfulness requirement is satisfied if the responsible person becomes aware of unpaid withholding taxes and then pays other creditors.

The bankruptcy court[167] denied a debtor's request for an abatement of unpaid withholding taxes, penalties, and interest. The court has ruled that financial difficulties can never constitute reasonable cause for failure to pay taxes. The court rejected the taxpayer's reliance on *Glenwal-Schmidt and Pool*[168] and *In re Pool & Varga Inc.,*[169] stating that those cases "have been criticized by other courts

[163] *Thibodeau supra* note 162 at 1505.
[164] *Smith*, *supra* note 166.
[165] *Thibodeau supra* note 162 at at 1506.
[166] 15 F.3d 181 (5th Cir. 1994) *aff'g* 160 B.R. 557 (E.D. Tex. 1992).
[167] *In re Upton Printing Co.*, 186 B.R. 904 (Bankr. E.D. La. 1995).
[168] *Glenwal-Schmidt v. United States*, 78-2 USTC ¶ 9610 (D.D.C. 1978).
[169] 60 B.R. 722 (Bankr. E.D. Mich. 1986).

as anomalous and not well-reasoned."[170] The court noted that "reasonable cause for failure to pay withholding taxes [is] limited to situations [involving] . . . circumstances outside the taxpayer's control, such as the failure of a financial institution." The court wrote that "financial difficulties can never . . . constitute reasonable cause," because "[a]lmost every non-willful failure to pay taxes is the result of financial difficulties." The court added, "the government cannot be made an unwilling partner in a floundering business."

The Tenth Circuit, affirming a district court opinion, held that the taxpayer is liable for the "responsible person" penalty under I.R.C. section 6672 and that he acted willfully in failing to remit his company's withholding taxes shortly before the company filed for bankruptcy.[171] Prior to the filing of the petition, the taxpayer had attempted to pay the overdue taxes with checks that were dishonored. The taxpayer asserted that he did not know the checks would be dishonored and that the IRS should have resubmitted the checks. The taxpayer also asserted that he was not the person responsible for paying the company's trust fund taxes for part of the period at issue, because the company had filed for bankruptcy before the taxes were due.

The Tenth Circuit stated that its consideration of willfulness begins with the responsible party's actions from the moment the employees' net wages are paid and taxes are withheld. The court noted that, rather than segregate the trust fund taxes, the taxpayer had used them to cover the company's operating expenses, which had the effect of treating the government as a partner in his failing business and increasing the risk that the company would be unable to remit the funds when due. The Tenth Circuit pointed out that the taxpayer's filing of a bankruptcy petition on the company's behalf two days prior to the quarter's end did not change his status as the person responsible for collecting the taxes in the first instance.

(ii) IRS Procedure

When the IRS believes that a company's employment taxes are not going to be paid, it begins an investigation to determine the responsible person(s). The IRS may:

1. Review records, including articles of incorporation, bylaws, and book of minutes;
2. Examine signature cards and canceled checks to determine who had authority and who actually signed checks;
3. Establish the responsibility for other financial affairs, such as loan applications and financial statements;
4. Review corporate tax returns to see who signed them;
5. Interview individuals who appear to be liable or who have information to help determine who is actually responsible for the unpaid tax.[172]

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[170] *Citing Brewery Inc. v. United States*, 93-2 USTC ¶ 50,479 (S.D. Ohio 1993).
[171] *Kelley v. United States*, 68 F.3d 483, 1995 U.S. App. LEXIS 28036; 95-2 U.S. Tax Cas. (CCH) P50,561; 76 A.F.T.R.2d (RIA) 6839 (10th Cir. 1995).
[172] *Westfall*, *supra* note 141

After the investigation has been completed, the IRS sends letters to the responsible persons advising them of their liability for the penalty, requesting their agreement, and informing them of their appeal rights. A person may contest the proposed assessment by filing a written protest for a hearing, if the tax owed for any year or period exceeds $2,500. The letter of protest should identify the item being contested and include a statement of facts supporting the objection. If the taxpayer is unsuccessful in the protest, any subsequent appeal will be handled by the appeals office of the IRS, which is separate from the collections office.[173]

In cases where a chapter 11 petition is filed, the IRS may make an immediate assessment against the responsible person or wait until the tax issues are resolved in the case. The assessment and collection of this penalty may be delayed, pending a determination of whether the corporation will be able to pay the tax based on the confirmed plan of reorganization. If the plan proposes to pay the entire tax plus all penalties and interest upon confirmation, then the assessment will generally be held back to see whether the payment is received. If the plan calls for the trust portion of withholding tax to be paid over 6 years, the IRS will often elect to go ahead and collect the trust portion from the responsible person. In *In re William Netherly,*[174] the bankruptcy court would not enjoin the IRS from collecting the trust portion of withholding tax from Netherly, the president and responsible person, even though the confirmed plan provided for deferred tax payments of $4,925 per month including interest.

In *Arve Kilen v. United States,*[175] the bankruptcy court held that it is possible for the bankruptcy court to determine a responsible person obligation for unpaid withholding taxes before the IRS assesses the tax. In *United States v. David R. Kaplan,*[176] the district court also held that the bankruptcy court had jurisdiction to determine the responsible person under I.R.C. section 6672.

In *Kilen,* Arve Kilen was an owner, director, or officer of 31 bankrupt corporations, some of which listed trust fund tax liabilities on the schedules filed with the court. Kilen filed an individual chapter 11 petition in November 1987 and earmarked approximately $640,000 in the plan to satisfy his personal liability for unpaid withholding taxes owed by the corporations.

The IRS filed a proof of claim against Kilen for only the unpaid taxes of one corporate debtor and the 100 percent penalties under I.R.C. section 6672 from two companies. Kilen filed a proof of claim on behalf of the government in his own case for his total trust fund tax liability. He then filed an adversary complaint objecting to the claims filed by the government and requesting the court to determine his trust fund tax liability.

The government objected to the complaint and argued that the case between itself and Kilen was not ripe for adjudication because the IRS had not filed a proof of claim on behalf of the government or issued a proposed assessment and, in fact, might never do so.

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[173] *Id.*

[174] 53 B.R. 856 (Bankr. M.D. Fla. 1985).

[175] 129 B.R. 538 (Bankr. N.D. Ill. 1991).

[176] 146 B.R. 500 (D. Mass. 1992).

The bankruptcy court denied the government's motion to partially dismiss Kilen's complaint. The court found that, although the IRS had not filed a proof of claim or assessed a tax deficiency for the trust fund tax liability for the 29 bankrupt companies, a case or controversy existed between the IRS and the debtor within the meaning of Article III of the Constitution.

Citing *Abbott Laboratories v. Gardner*,[177] the court noted that the case was ripe for determination. The court indicated that the harm to Kilen (funds would go to pay unsecured creditors and he would still be personally liable for the trust fund taxes) outweighed any perceived problems with speculation or contingency.

Even if the government does not use its full power or exercise due diligence to collect the withholding tax, the responsible person is still liable for the tax. The District Court held, in *V.A. Davel*,[178] that the liability of the responsible person is independent of the employer-corporation's obligation to remit the employee withholdings. In *Robert W. Sawyer*,[179] the court held that the IRS is not required to proceed against the corporation for delinquent employee withholding taxes before collection of those taxes from a corporate officer. The District Court's decision was reversed on an unrelated procedural issue and the taxpayer was allowed to present evidence as to the reason why the willfulness standard under I.R.C. section 6672 was not satisfied.[180]

The responsible person may find that if a proposed or confirmed plan does not call for full payment of the tax upon confirmation, then the IRS immediately assesses the penalty and issues an account to the field to effect collection. This can include the filing of a Notice of Federal Tax Lien against the responsible person or persons and the seizure of assets or levying the bank accounts, wages, or other cash assets of the person. Even if payment through the plan of reorganization will eventually fully pay the tax, the penalty will be assessed because the government has no guarantee that these deferred payments will ever be completed. If, eventually, the government does receive its full payment through the plan, then the responsible person from whom the penalty was collected can file a claim with the government for refund of the penalty payments. This policy should not be interpreted as being all-inclusive and unbending.

If the plan proposes to pay the entire tax plus all prepetition penalties and interest upon confirmation, the assessment will generally be held back until it is determined whether the payment will actually be made.

In a bankruptcy case, the IRS may complete the investigation to determine the responsible persons and mail letters to these individuals. Their action normally stops at this point unless the statutory period for assessment is about to elapse. With respect to any taxable period within the calendar year, the statute is open for 3 years from April 15 of the following year or from the date the return was filed, whichever is later. For example, if Form 941 was timely filed for the first quarter of 19X4, the statute would start running on April 15, 19X5. The statutory period does not start to run until the return is filed.

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[177] 387 U.S. 136 (1967).
[178] 87-2 USTC (CCH) ¶ 9462 (D.C. Wis. 1987).
[179] 86-2 USTC (CCH) ¶ 9745 (N.D. Ind. 1986).
[180] *Sawyer v. United States*, 831 F.2d 755, (7th Cir. 1987).

If, in a bankruptcy case, the statutory period is about to expire, the IRS may request a written agreement with the responsible person or persons to extend the statutory period. If the individual refuses to sign the extension, the IRS will normally make an assessment before the statutory period expires. The IRS has 6 years to collect the tax after the assessment is made.

(iii) Designation of Payments

Unless the taxpayer designates how payments are to be made, the IRS will most likely apply payment to the non-trust-funds portions first. If a plan of reorganization provides for only the payment of taxes plus interest to the date of the petition, the IRS will apply payment to the non-trust funds first and then to interest, before applying any to the trust part. In *United States v. DeBeradinis,*[181] the court held that, if payments are not designated as to how they are to be allocated, the IRS may designate the collections according to its policy. If the plan calls for the IRS to receive full payment of all taxes, penalty, and interest, payment may be applied in the following order:

1. Non-trust-fund taxes;
2. Interest to petition date;
3. Assessed and accrued penalties and interest;
4. Trust fund taxes.

The IRS will not follow the above order if the taxpayer specifically designates that the payment is to be handled differently. IRS Policy Statement P-5-60[182] states that the taxpayer has no right of designation in the case of collections resulting from enforced collection measures. Bankruptcy courts were not in agreement as to the extent a bankruptcy case causes the payments to be involuntary.

The Tax Court, in *Amos v. Commissioner,*[183] stated: "An involuntary payment of Federal Taxes means any payment received by the agents of the United States as a result of distraint or levy or from a legal proceeding in which the government is seeking to collect its delinquent taxes or file a claim thereof." Several cases have held that payments made by a taxpayer involved in a bankruptcy proceeding are involuntary.[184] In other cases, the courts have ruled that they are involuntary.[185] Under the Bankruptcy Code, there is considerable uncertainty as to whether the payments are voluntary or involuntary. It has been suggested that payments made in a chapter 11 reorganization case are voluntary, while those in a chapter 7 liquidation or a chapter 11 liquidation are involuntary. However, the courts in *Avildsen* rejected this idea and considered the payments

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[181] 395 F. Supp. 944 (D. Conn. 1975), *aff'd,* 538 F.2d 315 (2d Cir. 1976).
[182] IRS Manual M.T. 1218-157.
[183] 47 T.C. 65, 69 (1966).
[184] *For example, see O'Dell* 326 F.2d 451, 456 (10th Cir. 1964); *Monday*, 73-2 USTC (CCH) ¶ 9589 (7th Cir. 1973); *Avildsen Tools*, 764 F.2d 1248 (7th Cir. 1986).
[185] *See Tom LeDuc Enterprises, Inc.*, 84-2 USTC (CCH) ¶ 9928 (D.C. Mo. 1984).

voluntary.[186] Avildsen filed its petition under Chapter XI of the Bankruptcy Act and liquidated under Chapter XI to take advantage of its tax loss carryforward. Under the Bankruptcy Code, this type of plan would most likely be considered a liquidation plan; as a result, the tax payments might appear to be considered differently than would be the case in a reorganization under chapter 11. However, in *Energy Resources*,[187] the court held the tax payments made by a liquidating trustee in a chapter 11 case were voluntary.

Whether the payments are voluntary or involuntary was examined in at least four other circuit court decisions. The Third Circuit held, in *In re Ribs-R-Us*,[188] that payments of taxes by a debtor in a chapter 11 reorganization are involuntary. The court noted that to consider the payments as voluntary is inconsistent with the realities of bankruptcy. The Sixth Circuit followed the Third Circuit's decision in *Ribs-R-Us* and held that the payments are involuntary.[189]

However, the Eleventh Circuit concluded that the decision as to whether tax payments made under a chapter 11 reorganization plan are voluntary (thereby allowing taxpayer allocation) is best made on a case-by-case basis with consideration of each bankruptcy plan as a whole.[190] The conditions to be considered in deciding whether the payments are involuntary are: the history of the debtor; the absence or existence of prebankruptcy collection or enforcement measures of the IRS against the corporation or responsible corporate officers; the nature and contents of a chapter 11 plan (e.g., last-resort liquidation or reorganization); the presence, extent, and nature of administrative and/or court action; the presence of pre- or postbankruptcy agreements between the debtor (or trustee) and the IRS; and the existence of exceptional or special circumstances or equitable reasons warranting such allocation. The court noted that the bankruptcy judge should most importantly consider whether the proposed plan is merely a stopgap scheme to hold the taxing authority at bay, with little chance that the debtor will fulfill its obligation under the plan.

The Ninth Circuit has ruled, in *In re Technical Knockout Graphics, Inc.*,[191] that preconfirmation tax payments are involuntary. Thus, the IRS may allocate them as it directs. This decision differs from *Ribs-R-Us* and *A & B Heating and Air Conditioning* in that payments in these cases are a part of the approved plan. In *Technical Knockout Graphics*, the payments were made prior to the approval of the plan. It should be noted that in this case the decision was related to the court's lack of jurisdiction to order the designation of the payments. The court noted that the debtor is not free to abuse this system (authority of the court to keep the creditors at bay while the debtor reorganizes) by "designating its payments in a way that benefits only its responsible persons, and possibly harms other

[186] 764 F. 2d 1248.

[187] 59 B.R. 702 (Bankr. D.C. Mass. 1986), *aff'd*, 871 F.2d 223 (1st Cir. 1989), *cert. granted*, 493 U.S. 963 (1989).

[188] 828 F.2d 199 (3d Cir. 1987).

[189] *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988).

[190] *In re A & B Heating and Air Conditioning*, 823 F.2d 462 (11th Cir. 1987).

[191] 833 F.2d 797 (9th Cir. 1987).

creditors, including the IRS, without the scrutiny of the court or the other creditors." Even though *Ribs-R-Us* related to the designation of payments in a plan, the court in *Technical Knockout Graphics* noted with approval the decision of the Third Circuit.

In *Energy Resources Co.,*[192] the district court upheld the bankruptcy court's decision that the trustee in a chapter 11 case can designate the IRS to apply payments to the trust fund part of the tax liability. The IRS refused to accept this designation and argued that these payments made under a court-approved plan were involuntary and thus could not be designated by the trustee. The court indicated that its role in a voluntary chapter 11 reorganization is limited to the approval of the debtor's designated plan within the limits of section 1129 of the Bankruptcy Code. The court approves a payment that the debtor wants to make. (It is interesting to note that Energy Resources was liquidating under chapter 11.)

The IRS appealed the district court's decision in *Energy Resources.* The First Circuit held that the bankruptcy court had "broad equitable powers" to make orders necessary to carry out the provisions of the Bankruptcy Code. The appeals court noted that, where responsible officers agreed to advance funds to a reorganized corporation only on the condition that the corporation first pay the taxes, the diminished chance that the government would collect its entire tax debt was outweighed by the increased chance that the debtor would be able to pay something to its general creditors.[193]

On appeal,[194] the Supreme Court ruled that a bankruptcy court can direct the IRS to apply a debtor's payment to trust fund employment taxes, even though doing so might leave the government at risk for non-trust-fund taxes. The Court did not decide whether tax payments were voluntary or involuntary, but rather held that a bankruptcy court's broad "authority to modify creditor-debtor relationships"[195] entitled it to direct the debtor's payments toward withholding taxes, even though doing so might endanger the government's collection of other debtor liabilities.

As noted above, in *In re Energy Resources Co., Inc.,*[196] the Court held that the bankruptcy court has the discretion to determine whether the interests of all the parties would best be served by allowing the debtor to set the order in which the trust fund taxes, interest, penalties, employer's taxes, and other taxes will be paid.

In a legal memorandum to district counsel, the chief, branch 3 (general litigation), has advised that the Service can disregard the trustee's designation of payments after a chapter 13 bankruptcy has been dismissed, but may not want to apply payments retroactively.[197]

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[192] 87-2 USTC (CCH) ¶ 9611 (D. Mass. 1987).
[193] *United States v. Energy Resources Co., Inc.*, 871 F.2d 223 (1st Cir. 1989).
[194] 495 U.S. 545 (1990).
[195] *Id.*
[196] 871 F.2d 223 (1st Cir. 1989), *aff'd, United States v. Energy Resources Co.*, 110 S. Ct. 2139 (1990).
[197] ILM 199924006; LTRServ, June 18, 1999, p. 5252.

In a chapter 13 filing, the Service filed a proof of claim, including (1) a secured claim for taxes from 1986 through 1989; (2) an unsecured priority claim for taxes from 1995 to 1997; and (3) an unsecured general claim for penalties for 1982 and 1983. The individual made eight payments of $100, and the trustee designated each payment for 1986. Eight months later, the individual voluntarily dismissed the chapter 13 filing. District counsel wanted to know if the IRS can disregard the trustee's designation and apply all or part of the $800 in its "best interest."

The Service noted that in a chapter 11 case, *U.S. v. Energy Resources Co., Inc.*,[198] the bankruptcy court has authority to designate how payments are to be applied, even if they are involuntary payments. The issue, according to the Service, was not clear in chapter 13 cases. The court noted that both the legislative history of section 349(b) of the Bankruptcy Code and *In re Nash*[199] support the argument that after a chapter 13 case is dismissed, the trustee's designation of payments is no longer effective. The Service noted, however, that whether payments that were received before the bankruptcy's dismissal may be retroactively reapplied was not clear and that it might not be in the Service's best interest to redesignate payments retroactively. Although the Service concluded that it was not prohibited from retroactively applying the payments, it determined that the decision should be made on a case-by-case basis.

Several bankruptcy courts had held that payments in chapter 11 (as opposed to chapter 7) are voluntary payments and therefore the payee can designate how they are to be applied.[200] In an assignment for the benefit of creditors, the court held that the payments were voluntary.[201] Cases holding that the payments to the IRS for trust fund taxes in a chapter 11 plan were involuntary include *In re Frost* and *In re Mister Marvins, Inc.*[202]

In *United States v. Kare Kemical, Inc.*,[203] Kare Kemical Co. proposed a plan of liquidation that required the IRS to first satisfy the principal portion of the firm's tax obligation and thereafter the accrued interest and penalties. The plan was approved by the bankruptcy court, which found sufficient elements of voluntariness to permit payment allocation. The district court affirmed. The Eleventh Circuit reversed the lower courts and held that the Supreme Court's reasons for allowing payment allocation in reorganizations are not present in liquidation cases.

In *In re Deer Park Inc.*,[204] the Ninth Circuit allowed the debtor to allocate payments. An involuntary chapter 11 proceeding was filed against Deer Park Inc.,

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[198] 495 U.S. 545, 110 S.Ct. 2139 (1990).

[199] 765 F.2d 1410 (9th Cir. 1985).

[200] *In re The Franklin Press, Inc.*, 52 B.R. 151 (Bankr. S.D. Fla. 1985); *In re Lifescape Inc.*, 54 B.R. 526 (Bankr. D. Colo. 1985); *Ducharmes & Co. Inc. v. United States*, 75 B.R. 71 (E.D. Mich. 1987), *rev'd*, 852 F.2d 194 (6th Cir. 1988); *in re Tom LeDuc Enterprises, Inc.*, 47 B.R. 900 (W.D. Mo. 1984).

[201] *Muntwyler v. United States*, 82-1 USTC ¶ 9252 (D.C. Ill. 1982), *aff'd*, 703 F.2d 1030 (7th Cir. 1983).

[202] 47 B.R. 961 (Bankr. D. Kan. 1985); 48 B.R. 279 (Bankr. E.D. Mich. 1984).

[203] 935 F.2d 243 (11th Cir. 1991).

[204] 10 F.3d 1478 (9th Cir. 1993).

developer of a ski resort. The proof of claim filed by the IRS included a claim for withholding taxes for which Deer Park's president, Gerald Stoll, was liable. Based on comments from an IRS agent, the plan was modified to apply the payments it received under the plan to Deer Park's trust fund tax liability.

The Ninth Circuit affirmed and cited *United States v. Energy Resources Co.,*[205] where the Supreme Court held that a bankruptcy court has the authority to order the IRS to apply payments to trust fund liabilities if the court determines that the allocation is necessary to the success of a reorganization plan. The Ninth Circuit noted that most of the IRS's arguments were rejected in *Energy Resources.* The court also rejected the IRS's argument that *Energy Resources* does not apply to a chapter 11 plan of liquidation, citing *In re Gregory Engine & Machine Services Inc.*[206] The court reasoned that such an allocation provides an incentive for officers and managers to assist in a debtor corporation's reorganization. The Ninth Circuit then ruled that the bankruptcy court did not err in finding that Stoll's participation was essential to the success of the plan. The court noted that, because of his experience with Deer Park, his contacts, and his commitment to the fulfillment of the plan's contingencies, Stoll was the person most likely to make a reopening of Deer Park succeed.

Circuit Judge Warren J. Ferguson dissented because he could find no reason to believe that relieving Stoll of his personal tax liability would cause Alpine to reopen Deer Park. Such a conclusion, Ferguson stated, "defies ordinary business sense."

In *In re Flo-Lizer Inc.,*[207] the district court let stand an order where the bankruptcy court ordered the IRS to allocate trust fund payments to withholding taxes in a chapter 11 liquidation case.

Flo-Lizer Inc. filed a chapter 11 bankruptcy petition and submitted a plan of liquidation. The corporation's principals contributed personal resources to the plan with the understanding that the IRS would not attempt to collect unpaid withholding tax liabilities from them. The company made a payment on the IRS's administrative expense claim, and requested that the payment be applied to the trust fund portion of its liability. The IRS applied the distribution first to penalties and then to principal and interest. The bankruptcy court ordered the IRS to apply the payment to the trust fund portion of the liability. The government appealed.

The district court affirmed the bankruptcy court's decision, citing *United States v. Energy Resources Co.,*[208] where the Supreme Court ruled that a bankruptcy court may order the IRS to apply a debtor's payments first to the trust fund portion of the tax debt if such a designation is necessary for a reorganization's success. The district court noted that some courts of appeals have refused to extend the same reasoning to liquidation cases, but found that the Ninth Circuit applied *Energy Resources* to a chapter 11 liquidation.

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[205] 495 U.S. 545 (1990).
[206] 135 B.R. 807 (Bankr. E.D. Tex. 1992).
[207] 164 B.R. 749 (S.D. Ohio, 1994).
[208] 495 U.S. 545 (1990).

In *In re M.C. Tooling Consultants Inc.,*[209] the bankruptcy court determined that the allocation of trust fund payments was necessary for an effective reorganization. The court noted the president's testimony that, following the filing of the bankruptcy petition, he was so harassed by the IRS about his personal liability for the taxes that he could not concentrate on business operations.

The district court held, in *In re Suburban Motors Freight Inc.,*[210] that the bankruptcy court should not have directed the allocation of tax payments in a chapter 7 case. Suburban Motors Freight Inc. failed to pay withholding taxes from March 1986 through January 1987. In November 1991, the company filed a chapter 7 petition five months after the IRS assessed a 100 percent penalty against the company's president under I.R.C. section 6672. The president filed a motion requesting the bankruptcy court to direct the trustee to distribute part of the estate's funds to pay the IRS's claim for the trust fund part of the claim. The bankruptcy court ordered the trustee to make a partial distribution to all undisputed tax claims, including the trust fund liability, and to pay all priority wage claims.

The district court held that the bankruptcy court was not entitled to direct the allocation of Suburban's tax payment, because Suburban had not shown the need for a reorganization or similar purpose.

In *In re T. Craft Aviation Service Inc.,*[211] the bankruptcy court relieved the IRS of the obligation to allocate the funds as previously instructed, because the allocation request was for a mandatory injunction and it was improper to bury the request in the trustee's final report. Because improper notice was given, the court examined the Supreme Court's ruling in *United States v. Energy Resources Co. Inc.,* in which the court held that the bankruptcy court could direct the allocation of tax funds because such an order was necessary to ensure the success of the [chapter 11] reorganization. The court, "[o]pining that permitting the bankruptcy court to exercise such authority permits the creation of tax-dodgers havens by shifting the burden of paying taxes from the corporate principals to the general unsecured creditors," also noted that there is no reorganization plan in a chapter 7 proceeding. The court concluded that an allocation order by the bankruptcy court is not proper.

The bankruptcy court denied a couple's application to reallocate to nondischargeable tax debts the payments the bankruptcy trustee made to the IRS in the couple's chapter 7 case.[212] The court held that payments made by a chapter 7 trustee are involuntary payments, and as a result, the debtor may not direct that such payments be allocated to a specific tax obligation or tax period. The court refused to apply *United States v. Energy Resources Co.* to chapter 7 proceedings and distinguished liquidating distributions in chapter 7 from payments made to reorganize a debtor under chapters 11 and 13.

The Eleventh Circuit, reversing both the district and bankruptcy court decisions, held that the federal income tax return filed by a couple qualified as a refund claim but that the couple was not entitled to direct the IRS's application

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[209] 165 B.R. 590 (Bankr. D. S.C. 1993).

[210] 161 B.R. 640 (S.D. Ohio 1993).

[211] 187 B.R. 703 (Bankr. N.D. Okla. 1995).

[212] *In re Ferguson*, 197 B.R. 161 (Bankr. S.D. Fla. 1996).

of the overpayment.[213] The taxpayer directed that the overpayment be made to a tax liability for 1989. The Service applied it to the tax liability for 1986.

The Eleventh Circuit noted that Treas. Reg. section 301.6402-3(a)(5) demonstrates that the IRS does not apply the voluntary payment rule to overpayments. The decision by the Eleventh Circuit was consistent with the Second Circuit's ruling in *Kalb v. United States.*[214] In *Kalb*, the Second Circuit held that I.R.C. section 6402(a) clearly gives the IRS discretion to apply a refund to any liability of the taxpayer.

The Third Circuit determined that the bankruptcy court did not have the authority to authorize the IRS to allocate trust payments not properly allocated at the time of the payment of trust fund taxes by a responsible officer on behalf of the corporation that was not in bankruptcy.[215] The Third Circuit concluded that under section 105(a) of the Bankruptcy Code, such retro allocations of trust payments by a nondebtor were justified.

In *In re Ramos*,[216] the bankruptcy court held that payroll trust fund taxes paid because of a levy were involuntary and the IRS could allocate the payment to interest and penalties first. The court noted that the IRS had no obligation to benefit the debtor in its allocations.

If an asset that has previously been tendered to the IRS as payment of trust funds is liquidated during the bankruptcy proceeding, the debtor, according to *In re Vermont Fiberglass, Inc.*,[217] should not be able to designate how the proceeds are allocated. Of course, officers, directors, and responsible employees want the first payment to cover the trust-fund portion of the tax claim, because they can be held personally liable for these taxes.

Restitution payments made as a result of being convicted of tax evasion were held to be involuntary payments granting the Service the right to allocate the payments.[218]

(iv) Enforcement of Liability Against Officers

It appears that, in general, a corporation in bankruptcy cannot prevent the IRS from enforcing the tax liability against the responsible persons. Most courts are now holding that the individual and the corporation are two separate entities, and one entity cannot litigate the tax liabilities of the other even though the corporation has a stake in the outcome of the proceedings against its officer and such proceedings may imperil the reorganization of the debtor. In *Bostwick v. Commissioner*,[219] the court held that the bankruptcy court had the power, but in *In re Becker's Transportation, Inc.*,[220] the court held that it was the intent of Congress not to permit bankruptcy courts to issue such injunctions. However, in a

[213] *In re Ryan*, 64 F.3d 1516 (11th Cir. 1995).
[214] 505 F.2d 506 (2d Cir. 1974), *cert. denied*, 421 U.S. 979 (1975).
[215] *In re Kaplan*, 104 F.3d 589 (3rd Cir. 1997).
[216] 1992 Bankr. LEXIS 1665; 93-1 USTC (CCH) 50,069 (M.D. Fla. 1992).
[217] 88 B.R. 41 (D. Vt. 1988) *rev'g* 76 B.R. 358 (Bankr. D. Va. 1987).
[218] *In re Tecson*, No. 01-09728-3P1 (Bankr. M. D. Fla. 2003).
[219] 521 F.2d 741 (8th Cir. 1975).
[220] 632 F.2d 242 (3d Cir. 1980).

subsequent case,[221] the Eighth Circuit held that the bankruptcy court could not enjoin the IRS. The Seventh Circuit[222] also held that the bankruptcy court cannot enjoin the IRS from assessing a penalty against the owners of a business in chapter 11 for failure of the business to remit withholding taxes. The circuit court determined that enjoining the IRS from assessing the 100 percent penalty would facilitate the reorganization of the debtor. The appeals court held that there was no indication in the Bankruptcy Code that Congress intended to override the Tax-Anti-Injunction Act (I.R.C. section 7421).

Several bankruptcy courts have, however, enjoined the IRS from deducting the withholding tax penalty from principals of corporate debtors because their action would detrimentally affect the debtors' reorganization.[223] The IRS is appealing most of these decisions. In *Driscoll's Towing Service,* the judge determined that an injunction order was appropriate because the plan confirmed by the court provided for (1) a waiver of personal liability of the debtor's principals at the successful completion of the plan's payment provisions and (2) abatement of claims during the pendency of payments.[224] The district court, however, reinstated the 100 percent penalty, stating that the bankrupt corporation lacked standing to contest the tax liability of its principals.[225]

In *In re Earnest S. Regas Inc.*,[226] the chapter 7 trustee and the IRS reached an agreement where the trustee was to disburse a certain amount of the tax claim in complete satisfaction of all of the corporation's tax liabilities. The court subsequently issued an order that reflected the nature of the agreement but also stated that the payment to the IRS would fully discharge the corporation's officers and directors from any additional tax liability owed by the debtor.

The government noticed the error and agreed with the trustee to an amendment to the order. When the IRS attempted to collect the unpaid taxes from various responsible persons under I.R.C. section 6672, Yvonne Regas moved to enforce the first court order. The bankruptcy court held that the amendment to the order was void because proper notice had not been sent to creditors and other interested parties.

The government appealed and the district court reversed the bankruptcy court's denial of the government's motion to correct the order. The district court rejected the bankruptcy court's finding that the original order did not contain a "clerical" error that could be simply corrected under rule 60 of the Federal Rules of Civil Procedure. The district court found that the government and the trustee clearly did not intend the agreement to contain such language. As with most other district courts, this court ruled that the bankruptcy court lacked jurisdiction to order such a result because the original order had the effect of determining the tax liability of nondebtors.

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[221] *A to Z Welding & Mfg. Co.*, 803 F.2d 932 (8th Cir. 1986).

[222] *In re LaSalle Rolling Mills*, 87-2 USTC (CCH) ¶ 9592, 832 F.2d 390 (7th Cir. 1987). *See Rayson Sports, Inc.*, 84-2 USTC (CCH) ¶ 9968 (D.C. Ill. 1984).

[223] *Driscoll's Towing Service, Inc.*, 43 B.R. 647 (Bankr. S.D. Fla. 1984).

[224] *Id.*

[225] *In re Driscoll's Towing Service*, 85-2 USTC (CCH) ¶ 9603, 51 B.R. 990 (Bankr. S.D. Fla. 1985).

[226] 1993 U.S. Dist. LEXIS 12324 (D. Nev. 1993).

In *Charles E. Bradley et al. v. United States,*[227] the "responsible person" is liable for interest that accrues during the bankruptcy case on an I.R.C. section 6672 tax penalty. From 1979 through 1981, Maxim Industries, Inc. failed to pay its trust-fund taxes. The IRS assessed the 100 percent penalty under I.R.C. section 6672 against Charles Bradley and David Agnew for the trust-fund taxes.

After its reorganization, the company paid the taxes and interest, except for the interest that accrued during the time the bankruptcy was pending. The IRS attempted to recover that portion of the interest from Bradley and Agnew. The district court held that Bradley and Agnew were liable for the interest that accrued during the case.

The Second Circuit affirmed the district court's holdings. The court held that, even though Maxim's tax liability was settled, the penalty under I.R.C. section 6672(a) was still appropriate, because the assessment is not derived from, or dependent on, an employer's outstanding tax obligation. It is assessed because of the failure of the responsible person to perform a statutory task. The Second Circuit noted that the liability for interest that accrued on the section 6672 penalty is similarly independent of the employer's liability for interest.

The determination of the responsible person and of the amount of the tax occurs outside the bankruptcy court proceedings. If, however, the responsible person files a bankruptcy petition, the bankruptcy court will determine the amount of the tax as well as the responsible person.[228]

(g) Tax Penalty

The priority granted a tax penalty depends on its nature. A tax liability that is called a penalty but in fact represents a tax to be collected is granted eighth priority. These penalties are referred to in Bankruptcy Code section 507(a)(8)(G) as "compensation for actual pecuniary loss."

In *Hanna v. United States,*[229] the Eighth Circuit held that penalties that are for "compensation for actual pecuniary loss" are entitled to the same priority as the tax to which they relate. Other prepetition penalties, including fines, forfeitures, and punitive damages, are not granted eighth priority, and in situations involving chapter 7 liquidations they are paid only after all unsecured debts have been satisfied (Bankruptcy Code section 726(a)(4)). Only amounts paid for postpetition interest and amounts paid to the debtor receive a lower priority in liquidation cases. If the tax penalty imposed by the IRS or other taxing units is penal in nature, it is not entitled to priority but would be considered along with other unsecured claims.

The tax penalty may be subordinated to the general unsecured creditors. Section 510(c) of the Bankruptcy Code provides in part:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may

[227] 936 F.2d 707 (2d Cir. 1991).
[228] *For example, see In re Allen M. Senall*, 64 B.R. 325 (Bankr. M.D. Fla. 1985).
[229] 872 F.2d 829 (8th Cir. 1989).

> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest.

It would appear that tax penalties for nonpecuniary losses might be subordinated. Equitable subordination in bankruptcy may be appropriate if the claimholder is guilty of inequitable conduct or if the claim itself is of a status susceptible to subordination. In the case of a nonpecuniary loss, courts have held that the claim is to be subordinated. Several courts have allowed the subordination.[230]

The Supreme Court held that a bankruptcy court's categorical subordination of the Service's section 4971(a) claim resulting from the debtor's failure to meet minimum funding requirements for a pension plan was erroneous.[231] The bankruptcy court, as well as the district court and the Tenth Circuit, had held that the Service's claim for the penalty should be subordinated under section 510 of the Bankruptcy Code to the claims of other general unsecured creditors. The court noted that the equitable subordination of the tax claim to all other unsecured creditors was the same type of categorical reordering of priorities that the Court had recently invalidated in *United States v. Noland.*[232] For a discussion of *Noland,* see § 11.2(b)(ii).

The bankruptcy court recommended that the district court grant a debtor a refund of interest paid on a section 4975 assessment for prohibited transactions involving an ESOP, because the section 4975 excise tax is a penalty.[233] According to the bankruptcy court, section 4975(a) is indistinguishable from section 4971 in its purpose, legislative history, and structured levels of sanctions.

In the case of a tax as opposed to a penalty, the Sixth Circuit, in *Mansfield Tire,*[234] declined the appellees' invitation to extend equitable subordination under section 510(c) of the Bankruptcy Code to include subordination of federal tax claims in the absence of some inequitable conduct on the part of the government, because claims for federal taxes are not claims of a type that is otherwise "susceptible to subordination."

The Sixth Circuit noted that the "courts are not free to independently decide whether the 'essential characteristic' of a federal exaction is that of a tax or a penalty in order to invoke equitable subordination. If Congress has decided that a particular levy is a 'tax' rather than a 'penalty,' for purposes of priorities in bankruptcy the matter is settled." As noted above, the Sixth Circuit held that the penalty under I.R.C. section 4971 was a tax.

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[230] *In re Colin*, 44 B.R. 806 (Bankr. S.D.N.Y. 1984) (subordination of punitive damage award); *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990) (subordination of nonpecuniary loss tax penalties); *In re Schultz*, 912 F.2d 230 (8th Cir. 1990) (subordination of nonpecuniary loss tax penalties). *See also Burden v. United States*, 917 F.2d 115 (3d Cir. 1990) (subordination of nonpecuniary loss tax penalties).

[231] *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 116 S. Ct. 2106 (1996).

[232] 116 S. Ct. 1524 (1996).

[233] *In re MMR Holding Corp.*, 1998 Bankr. LEXIS 1132; 82 A.F.T.R.2d (RIA) 6099 (Bankr. M.D. La. 1998).

[234] 942 F.2d 1055 (6th Cir. 1991).

An I.R.C. section 6698 penalty imposed for a late-filed partnership information return does not relate to a tax and therefore is not dischargeable under section 523(a)(7)(A) of the Bankruptcy Code.[235] In reaching this decision, the district court noted that the dischargeability of the late-filing penalty imposed on the taxpayer depends on whether the penalty is tied to a designated tax and whether the tax is dischargeable. The court held that the penalty does not relate to a tax and remanded for further findings on whether the taxpayer had reasonable cause for the delinquency.

The bankruptcy court largely sustained a chapter 11 corporation's objection to the IRS's claim for penalties under section 6721, finding that the company did not intentionally disregard its duty to file information returns. Under I.R.C. sections 6721 and 6722, a penalty of $50 per return may be imposed for a simple failure to file or to include all required information and a greater penalty of $100 per return for intentional disregard for the filing rules. The court noted that the distractions facing the debtor corporation's employees during the first three months of 1995—lawsuits, bankruptcy, and management changes—are a factor to consider in judging the debtor's failure to timely file the information returns. The court stated that "[t]his is not a case where Debtor's business was running smoothly and the filing requirements were merely ignored or treated frivolously."[236]

The bankruptcy court held that a couple's liability for the section 72(t) penalty for early withdrawal from a retirement plan was not discharged in their chapter 7 bankruptcy. The tax was not discharged because the obligation is a nonpecuniary loss penalty that became due less than three years before they filed for bankruptcy.[237]

The bankruptcy court noted that the fact that the exaction imposed by section 72(t) is labeled as a *tax* is not dispositive for purposes of section 523. Citing *United States v. Reorganized CF&I Fabricators of Utah Inc.*,[238] the bankruptcy court noted that the court must consider the purpose of the exaction. The bankruptcy court also noted that the Tenth Circuit held that the section 72(t) exaction is a penalty.[239] The bankruptcy court held that the penalty is not excepted from discharge under section 523(a)(7), because it is not compensation for pecuniary loss, it is not attributable to a dischargeable tax, and it became due within 3 years before the taxpayers filed for bankruptcy.

In a chapter 7 case, the bankruptcy court held that a couple's 1990 tax liability was not discharged under section 523(a)(1)(B)(i) of the Bankruptcy Code, because they never filed a return. However, because the return was due more than three years before the taxpayers filed for bankruptcy, the bankruptcy court

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[235] *Amici v. United States*, 197 B.R. 696 (M.D. Fla. 1996).

[236] *In re Quality Medical Consultants Inc.*, 192 B.R. 777 (Bankr. M.D. Fla. 1995); *aff'd* 214 B.R. 246 (M.D. Fla. 1997).

[237] *In re Mounier*, 232 B.R. 186 (Bankr. S.D. 1998).

[238] 518 U.S. 213 (1996).

[239] *In re Cassidy*, 983 F.2d 161 (10th Cir. 1992) (obligation is meant to deter the use of retirement funds for nonretirement purposes and is not intended to provide for the support of the Government).

held that the penalties on that deficiency were dischargeable under section 523(a)(7) of the Bankruptcy Code.[240]

The bankruptcy court rejected the taxpayers' argument that the failure to file a proof of claim barred its claim because the IRS was not required to file a proof of claim in the taxpayers' no-asset case.

In *United States v. Arthur Carol Sanford*,[241] the Eleventh Circuit held that the bankruptcy court did not have the power to partially disallow any of the penalties under I.R.C. sections 6651(a)(1) and (2) and 6654. The court noted that each penalty for each year is fully enforceable unless the taxpayer shows reasonable cause for failure to comply, in which case the penalty is unenforceable. According to the court, section 502(b)(1) of the Bankruptcy Code provides that a claim is not allowed in bankruptcy if it is unenforceable against the debtor outside of bankruptcy, but it does not vest the bankruptcy court with any equitable powers to reduce the penalties under I.R.C. sections 6651 and 6654.

In a chapter 7 liquidation case, as noted above, the penalties may not be paid. In *Simonson v. Granquist*,[242] the Supreme Court held that a provision like section 726 of the Bankruptcy Code prohibits the allowance of certain penalties without considering whether such penalties are secured by liens. Based on this ruling, it would appear that penalties that are not for actual pecuniary loss are not collectible by the IRS or other taxing authorities, once debts in a chapter 7 case are discharged. The IRS has, however, taken the position that the prepetition penalties, as well as prepetition taxes, survive a discharge in bankruptcy of an individual even though the government cannot collect the penalty in bankruptcy.[243]

(h) Interest

As under prior law, interest stops accruing when the petition is filed for purposes of determining prepetition liabilities. Interest that has accrued on prepetition taxes is considered part of the debt and would receive the same priority as the taxes received to which the interest applies. The list of tax claims in section 507(a)(8) of the Bankruptcy Code does not specifically include interest, but it has been held[244] that there is no indication that Congress intended to treat interest on a tax claim differently from the tax claim itself. The failure to include the interest in the list of eighth-priority items does not indicate that it should be excluded. Other courts have also held that prepetition interest is part of the tax claim.[245]

The Fifth Circuit, affirming decisions of the bankruptcy and district court, held that the interest paid under section 6621(c) above the rate of interest

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[240] *In re Timothy Richardson*, 1999 Bankr. LEXIS 547 (D. Ore. 1998).
[241] 979 F.2d 1511 (11th Cir. 1992).
[242] 369 U.S. 38 (1962).
[243] *See* cases cited in note 254.
[244] *In re H. G. D. & J. Mining Co.*, 74 B.R. 122 (Bankr. S.D. W. Va. 1986).
[245] *In re Healis*, 49 B.R. 939 (Bankr. M.D. Pa. 1985); *In re Elmer Eugene Palmer*, 86-2 USTC (CCH) ¶ 9592 (N.D. Tex. 1986); *In re Mary Frances Richcreek*, 81 USTC P. 9301, 1988 U.S. Dist. LEXIS 17335 (D.C. Ind. 1988); *In re Young*, 70 B.R. 43 (Bankr. S.D. Ind. 1987).

required under section 6621(a) is excepted from discharge under chapter 7 and is not a penalty.[246] In *In re Tuttle*, the Bankruptcy Court stated:

> Since the new Bankruptcy Code went into effect, a number of courts have applied the reasoning and result of Bruning not only to chapter 7 cases, but also to chapter 11 cases. See, for example, *Johnson v. IRS (In re Johnson),* 146 F.3d 252 (5th Cir. 1998) (chapter 7); *Hardee v. IRS (In re Hardee),* 137 F.3d 337 (5th Cir. 1998) (chapter 7); *Burns v. United States (In re Burns),* 887 F.2d 1541 (11th Cir. 1989) (chapter 7); *Hanna v. United States (In re Hanna),* 872 F.2d 829 (8th Cir. 1989) (chapter 7); *Ward v. Board of Equalization (In re Artisan Woodworkers),* 204 F.3d 888 (9th Cir. 2000) (chapters 11 and 12); *Fullmer v. United States (In re Fullmer),* 962 F.2d 1463, 1467-68 (10th Cir. 1992), overruled in part on other grounds in *Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13 (2000) (chapter 11). However, having considered a number of provisions in the new Code, particularly some in chapter 11 and chapter 13, this Court is convinced that the courts have been too hasty in applying *Bruning*, a liquidation case, to reorganization [**7] cases. Instead, the Code specifies how tax claims that would be nondischargeable in chapter 7 are to be paid in chapters 11 and 13 reorganizations, and it does not require gap interest to be paid.

The court noted that under Supreme Court precedent, a penalty is a fixed ad valorem amount, taking no account of time. The Fifth Circuit concluded that the increased rate of interest under section 6621(c) is truly interest because it is compounded daily and accrues only while the taxes remain unpaid and because the increase over the regular rate is not so significant as to be confiscatory in nature.

The Fifth Circuit agreed with the Seventh Circuit that interest is part of the underlying tax debt and is not a penalty.[247] Because the interest was assessed within 240 days of the taxpayer's bankruptcy filing, the court held that it was excepted from discharge.

The Tax Court refused to follow the provisions of *In re Hardee* in a nonbankruptcy situation.[248] However, on appeal the Fifth Circuit reversed the decision of the Tax Court as it related to the interest issue.[249]

On a prepetition tax that is nondischargeable, postpetition interest, according to 11 U.S.C. section 501(b)(2), will not be allowed. However, the IRS will attempt to collect the interest and has been successful in most cases because of the decision of the Fifth Circuit in *In re Hardee.* The Tenth Circuit decision in *In re Fullmer* and others have relied on the Supreme Courts decision in *Bruning.* Several courts that ruled that the interest may not be assessed by the IRS have been reversed. The bankruptcy court in the case of *In re Tuttle* after explaining in detail why the interest between the petition date and the confirmation date should not be allowed, then concluded that the court must rule that this interest was not discharged by confirmation of debtor's plan. Further, the IRS was not

[246] *In re Hardee*, 137 F.3d 337 (5th Cir. 1998).
[247] *In re Larson*, 862 F.2d 112 (7th Cir. 1988).
[248] *Copeland v. Commissioner*, T.C. Memo 2000-181, 79 T.C.M. (CCH) 2127; 2000 Tax Ct. Memo LEXIS 220.
[249] *Copeland v. Commissioner*, 290 F.3d 326 (5th Cir. 2002).

equitably estopped from collecting the gap interest by agreeing to the treatment it received under debtor's plan.[250]

In *In re Robert B. Quick, Jr.*,[251] the bankruptcy court held that the IRS can recover the postpetition interest and penalties assessed against the taxpayer on a tax claim that was not fully paid before the chapter 13 case was converted to chapter 7. The court found that, because the Quicks had not fully paid the tax liability prior to the dismissal of the chapter 13 case, the claim became nondischargeable and, consequently, personal liability for the interest survived the bankruptcy. The bankruptcy court noted that, because a decided case involving a conversion from a chapter 13 to a chapter 7 proceeding could not be found, the reasoning in *Bruning v. United States*,[252] which held that the "'traditional rule which denies postpetition interest as a claim against the bankruptcy estate' did not apply to 'discharge the debtor from personal liability for such interest,'" would be followed.

The court ordered the IRS to establish how the interest and penalty were calculated. If they were not calculated on the postpetition declining balance, the IRS must explain why deductions should not have been made for the payments made by the chapter 13 trustee.

In *In re Adelstein*,[253] the bankruptcy court held that the IRS is not to collect interest and penalties due to a delay in making payments on a settlement agreement reached in bankruptcy.

The IRS attempted to collect postpetition penalties and interest on a debt owed from the settlement agreement reached a year earlier, because of the delay in payment. The bankruptcy court ordered the settlement enforced and held that Adelstein was not liable for postpetition interest or penalties. The court noted that the settlement did not specify a time by which the taxes had to be paid and that the settled-on amount was all the IRS was due.

Treas. Reg. section 301.6611-1(h)(2)(v) was modified in 1994 to provide that interest is due as it accrues on a daily basis, rather than when it is assessed. In *Pettibone Corp. v. United States*,[254] the Appeals Court held that the former version of Treas. Reg. section 301.6611-1(h)(2)(v), which was in force throughout the

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[250] *In re Tuttle*, 259 B.R. 735 (D. Kan., 2000) *aff'd* 2001 Bankr. LEXIS 293 (Bankr. 10th Cir., 2001); *see Fullmer v. United States (In re Fullmer)*, 962 F.2d 1463, 1467-68 (10th Cir. 1992). For example, in *United States v. Benson*, 88 B.R. 210 (W.D. Mo. 1988), the district court (relying on *Bruning v. United States*, 376 U.S. 358, 363) held that there was no reason to make a distinction between a situation where taxes had gone unpaid and one in which a trustee had fulfilled the tax obligation, when determining whether the debtor should be liable for penalties and interest on the delinquent obligation. Other courts that allowed the postpetition interest and penalties include: *In re Woodward*, 113 B.R. 680 (Bankr. D. Ore. 1990); *In re Frost*, 19 B.R. 804 (Bankr. D. Kan. 1982), *rev'd*, 47 B.R. 961 (D. Kan. 1985); *In re Reich*, 66 B.R. 554 (Bankr. D. Colo. 1986), *rev'd*, 107 B.R. 299 (D. Colo. 1989) (debtor's liability for postpetition interest on a nondischargeable tax claim survives a discharge in bankruptcy as a personal liability, regardless of whether such claim has been fully paid from the estate); *In re Irvin*, 95 B.R. 1014 (Bankr. W.D. Mo. 1989), *rev'd*, 129 B.R. 187 (W.D. Mo. 1990).

[251] No. 87-01186 (Bankr. W.D. Va. Oct. 23, 1992).

[252] 376 U.S. 358 (1964).

[253] 167 B.R. 589 (Bankr. D. Ariz. 1994).

[254] 94-2 USTC (CCH) ¶ 76,066 (7th Cir. 1994).

reorganization and which provided that the due date of interest on underpayments was the date the interest was assessed, applies in this case. The court thus rejected the IRS's reliance on the new version of the regulation.

A bankruptcy court held that the IRS's claim for interest accruing on its unsecured priority claim from the filing of a chapter 11 petition to confirmation of the debtors' plan survives bankruptcy and can be asserted against the debtors personally, even though no provision for such interest was included in the confirmed plan.[255]

The BAP[256] found that the Service was entitled to "gap" interest accrued between the date of the debtor's bankruptcy filing and the date of confirmation of her chapter 11 plan. The BAP noted that it was bound by the existing Tenth Circuit precedent.[257] The court did not accept the argument that the Service was bound by the terms of the plan, which did not provide for "gap" interest. Rather the court found that under section 1141(d)(2) of the Bankruptcy Code the interest was the nondischargeable personal liability of the debtor.

Interest that accrues during bankruptcy proceedings on a prepetition debt would, according to section 726(a)(5) of the Bankruptcy Code, receive payment only after all other creditors' claims have been satisfied. The same general rule would apply in chapter 11 cases. In the case of secured debt, postpetition interest will be allowed, according to Bankruptcy Code section 506(b), to the extent that the value of the property exceeds the amount of the claim.

The Sixth Circuit held that interest on both secured and unsecured claims accrues until the claims are fully paid.[258] Because both the secured and unsecured claims were determined not to be impaired under the plan, the Sixth Circuit noted that the interest limitations under section 506(b) do not apply.

(i) Postpetition Interest on Secured Tax Claims

In *United States v. Ron Pair Enterprises, Inc.*,[259] the Supreme Court reversed the Sixth Circuit Court of Appeals and held that section 506(b) of the Bankruptcy Code entitled a creditor to receive postpetition interest on a nonconsensual, oversecured claim allowed in a bankruptcy proceeding.

Ron Pair Enterprises, Inc. (RPEI) had filed a petition for a chapter 11 reorganization on May 1, 1984, in the U.S. Bankruptcy Court for the Eastern District of Michigan. The government filed timely proof of a prepetition claim of $52,277.03, consisting of assessments for unpaid withholding and social security taxes, penalties, and prepetition interest. The claim was perfected through a tax lien on property owned by RPEI. The First Amended Plan of Reorganization (filed on October 1, 1985) called for full payment of the prepetition claims but did not provide for postpetition interest on that claim. Timely objection was filed by the government, claiming that section 506(b) of the Bankruptcy Code allowed recovery of postpetition interest because the property securing the

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[255] *In re Stacy*, 249 B.R. 683 (Bankr. W.D. 2000).
[256] *Tittle v. United States*, 2001 Bankr. LEXIS 293 (Bankr. 10th Cir. 2001).
[257] *In re Grynberg*, 986 F.2d 367 (10th Cir. 1993).
[258] *In re Monclova Care Center, Inc.*, F.3d (6th Cir. 2003).
[259] 109 S. Ct. 1026 (1989).

claim had a value greater than the amount of the principal debt. The parties stipulated at the bankruptcy court hearing that the claim was oversecured, but the court overruled the government's objection. On appeal, the U.S. District Court for the Eastern District of Michigan reversed the bankruptcy court's judgment, stating that the plain language of section 506(b) entitled the government to postpetition interest. Subsequently, the Sixth Circuit Court of Appeals reversed the district court.[260]

Section 506(b) of the Bankruptcy Code, which was enacted as part of the extensive 1978 revision, governs the definition and treatment of secured claims. Section 506(b) provides:

> To the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs or charges provided for under the agreement under which such claim arose.

A claim is secured only to the extent of the value of the property on which the lien is fixed; the remainder of that claim is deemed unsecured. Two types of secured claims exist: (1) voluntary (or consensual) secured claims (those created by agreement between the debtor and creditor and called a "security interest" by the code), and (2) involuntary secured claims, such as judicial or statutory liens, which are fixed by operation of law and do not require the debtor's consent. Because the government's claim here was a nonconsensual claim, the court focused on whether Congress intended that all oversecured claims be treated the same way for postpetition interest.

Under the Bankruptcy Act, the courts of appeal uniformly denied the government the right to interest on its tax liens, even though the value of the collateral was greater than the tax claim including postpetition interest. The courts did generally allow interest to be paid to a secured creditor where the collateral was large enough to pay both principal and interest. The courts justified postpetition interest in this situation because the creditor relied on the particular security given as collateral to secure both principal and interest.

The result of the paying of interest is to reduce the amount that is generally available for the payment of unsecured creditors. However, the courts justified the payment of postpetition interest on the assumption that the benefit of the secured creditors' bargain needed to be protected (e.g., see *United States v. Harrington*[261]). Prior law allowed postpetition interest to be paid on both consensual and nonconsensual claims in situations where the debtor ultimately proved to be solvent and in cases where the secured creditor's collateral produced income postpetition.[262]

The court held that the holder of an oversecured claim is entitled to postpetition interest and, additionally, to the right to the specified fees, costs, and charges. Recovery of postpetition interest is unqualified, whereas recovery of the fees, costs, and charges is allowed only if they are reasonable and provided for in the agreement under which the claim arose. In the absence of an

[260] 828 F.2d 367 (6th Cir. 1987).
[261] 269 F.2d 719 (4th Cir. 1988).
[262] *See* Bancroft, 62 *Am. Bankr*. L. J. 327, 330 (1988).

agreement, postpetition interest is the only additional recovery available. This reading of section 506(b) of the Bankruptcy Code is also mandated by its grammatical structure. The phrase "interest on such claim" is set aside by commas and separated from the reference to fees, costs, and charges by the conjunctive words "and any." The phrase therefore stands independent of the language that follows.

The pre-code practice of denying postpetition interest to holders of nonconsensual liens, but granting it to consensual lienholders, was an exception to the exception for oversecured claims and was based on the rule that the running of interest ceased when the bankruptcy petition was filed. This practice was recognized by only a few courts, and its application depended on particular circumstances. The "rule" was never extended to other consensual liens that were not "tax liens" and was only a guide to the trustee's exercise of power in the particular circumstances of the case.

The impact of the *Ron Pair Enterprises* decision may be significant in bankruptcy cases where there is a substantial tax liability. Interest over a period of several years on a material tax claim will result in unsecured creditors' receiving less. The IRS and other taxing authorities will most likely be encouraged by this decision to timely file tax lien notices in the proper location.

In *In re Shelus*,[263] a chapter 13 case, the court allowed the IRS to receive postpetition interest payments because there was a properly perfected tax lien on the residence and the tax claim did not exceed the value of the taxpayer's equity in the residence.

The IRS, prior to the Supreme Court decision in *Ron Pair Enterprises*, issued Rev. Rul. 87-99,[264] which holds that postpetition interest and pecuniary and nonpecuniary loss penalties may be claimed against the bankruptcy estate in a bankruptcy proceeding commenced on or after October 1, 1979, in general receiverships, or in cases involving assignment for the benefit of creditors.

This ruling declared obsolete Rev. Rul. 68-574,[265] which had held that postpetition interest generally will not be claimed by the IRS against a petition filed under the Bankruptcy Act, in general receivership, or in cases involving assignment for the benefit of creditors. The new ruling held that nonpecuniary loss penalties would not be claimed under Bankruptcy Act proceedings, but would be claimed in general receivership and in cases involving assignment for the benefit of creditors. The IRS also declared obsolete Rev. Rul. 71-31,[266] which had held that the IRS would not set off nonpecuniary loss penalties and postpetition interest against funds due to a bankrupt or insolvent estate where such claims would not be collectible.

This ruling will not interfere with the priority of tax claims in either assignment or bankruptcy cases. For example, nonpecuniary loss penalties may not, as a result of this ruling, be considered a priority tax under section 507 of the Bank-

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[263] 84-2 USTC (CCH) ¶ 9679 (Bankr. N.D. Tex. 1984). *See In re John D. Gilliland*, 67 B.R. 410 (Bankr. N.D. Tex. 1986).

[264] 1987-2 C.B. 291.

[265] 1968-2 C.B. 595.

[266] 1971-1 C.B. 408.

ruptcy Code. However, these penalties may be an unsecured claim according to this ruling.

In issuing this ruling, the IRS (1) noted that, under section 506(b) of the Bankruptcy Code, postpetition interest has been held to be recoverable on an oversecured claim,[267] and (2) claimed that postpetition interest is to be allowed when other postpetition claims for interest are allowed—when the estate has funds to pay all claims or when the value of the security interest in the debtor's property is greater than the debt. At the time the IRS issued Rev. Rul. 87-99, it was in conflict with the Sixth Circuit's decision in *Ron Pair Enterprises.* However, when the Supreme Court overturned this decision, the position of the IRS became fully enforceable.

In a receivership case involving an insurance company, the court ruled that the company was liable for postpetition interest on a federal tax lien.[268]

(i) Accruing Interest Expense

A business should evaluate its condition in a bankruptcy case to determine whether interest should be accrued and deducted for tax purposes. Bankruptcy Code section 506(b) provides that interest accruing after the petition is filed on prepetition secured claims will be allowed to the extent that the value of the property exceeds the amount of the claim. Thus, an accrual-basis taxpayer should consider the propriety of deducting the interest expense, as would be the case if the petition had not been filed. The fact that the payments are not current should not necessarily affect the decision to accrue the interest expense for tax purposes.

In the case of unsecured claims, the decision as to whether interest should be accrued depends on the extent to which all creditor claims are satisfied. Bankruptcy Code section 726(a)(5) provides that interest accruing during the proceeding on prepetition debt can be paid only after all other creditors' claims have been satisfied. Interest may also be paid in a chapter 11 case if unsecured creditors receive full payment of their claims. Thus, if it appears that all creditors' claims will be satisfied, the debtor should consider the propriety of accruing interest expense on prebankruptcy debt for tax purposes. If stock is going to be issued for debt, the right to deduct interest expense depends on the going-concern value of the debtor. To the extent that the debtor is solvent based on going-concern values, it would appear that interest could be deducted.

(j) Interest Receivable

As noted in § 11.2(h), interest is not paid on unsecured prepetition debt during the bankruptcy proceeding. The Bankruptcy Code does not, however, address the issue of whether interest on a receivable from the IRS should be paid. In *In re Pettibone Corp.*,[269] the district court ruled that the IRS did not owe interest on

[267] *Best Repair Co.*, 789 F.2d 1080 (4th Cir. 1986).

[268] *New York Insurance Co.*, 657 F. Supp. 27 (S.D.N.Y. 1986). *See also In re Pavone Textile Corp.*, 302 N.Y.2d 206, 97 N.E.2d 755 (1951); *United States v. Bloom*, 342 U.S. 912 (1952).

[269] 161 B.R. 960 (N.D. Ill. 1993).

prepetition overpayments during the bankruptcy proceeding. It should be noted, however, that this ruling was made in reference to the netting of prepetition claims and prepetition overpayments. As a general rule, it would be expected that the filing of a bankruptcy would not impact the amounts of claims that are owed to the company in bankruptcy.

(k) Interest Paid by Guarantor

Often, a shareholder of a closely held corporation will be required by a bank or other creditor to guarantee notes or other debt of the corporation. If the corporation files a bankruptcy petition and is subsequently discharged of its debt, and the guarantor must make the debt payments, interest paid by the individual is deductible as interest under I.R.C. section 163(a), according to *Benjamin Stratmore v. Commissioner*.[270] The court ruled that the status of the debt at the time the interest is paid, not when the debt was originally incurred, determines the tax consequence of the interest payment. Note that the interest in question was post-discharge interest. It appears that interest occurring prior to the discharge date is not deductible by the individual as interest expense.

(l) Erroneous Refunds or Credits

Section 507 of the Bankruptcy Code provides that a claim from an erroneous refund or credit of a tax will be treated in the same manner as the claim for the tax to which the refund credit applied. Thus, a refund received in error for income tax paid in 1995 will receive eighth priority if the tax liability incurred in 1995 would receive that priority. This provision would also apply to "quickie refunds" based on NOL carrybacks under I.R.C. section 6411.[271]

The bankruptcy court disallowed the Service's claim for interest on a section 6672 penalty against a woman, because the combined payments made by the woman and her ex-husband fully satisfied the assessment and the assessment was not revived when the IRS issued an erroneous refund to the ex-husband.[272] The taxpayer and her ex-husband fully satisfied the assessment for a section 6672 penalty. When the IRS credited the payment made by the taxpayer, it attributed it to her ex-husband and entered an incorrect date causing the computer to compute the interest liability as zero. The result was an automatically generated refund sent to the taxpayer's ex-husband in the amount of $12,600. The IRS subsequently released its tax lien against the property. The district court reversed[273] the bankruptcy court's order by following the Fifth Circuit decision in *US Life Title Ins. Co. on behalf*[274] and holding that under joint and several liability of I.R.C. section 6672, the tax liability is not paid until the statute of limitations period expires.

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[270] 785 F.2d 419 (3d Cir. 1986).
[271] *Id.* at 78.
[272] *In re Carol Janett Chene*, 1998 Bankr. LEXIS 1294; 98-2 U.S. Tax Cas. (CCH) P50,797; 82 A.F.T.R.2d (RIA) 6754 (Bankr. M.D. Fla. Sept. 28, 1998).
[273] *In re Chene*, 236 B.R. 69, (M.D. Fla. 1999).
[274] 784 F.2d 1238, 1243 (5th Cir. 1986).

The bankruptcy court held that tax assessments are extinguished upon full payment and are not revived by erroneous refunds.[275] When the IRS issues an erroneous refund, the Service must pursue an erroneous-refund action or make a new assessment, according to the bankruptcy court. The court did note, however, that *Bilzerian* and other cases following that rule involved income taxes, not responsible-person penalties. However, the court applied the rule to the responsible-person penalty and noted that in section 6672 penalty cases, the IRS is fully paid when the combined payments made by all responsible persons satisfies or exceeds the penalty amount. The court rejected the IRS's claim that it may collect the full amount from all responsible persons.

The Seventh Circuit held that an erroneous refund resulting in an overpay of taxes resulted in the Service having a tax claim for the unpaid taxes.[276]

Citing *McCollum v. United States*,[277] the bankruptcy court held that the IRS may be bound by the error of its agent when the error prejudices the taxpayer. The court found it clear that the taxpayer was prejudiced by the Service's error, because the IRS continued to compute interest on penalty that was already fully paid.

(m) Chapter 11 Reorganization

Section 1129(a)(9) of the Bankruptcy Code states that a plan must provide for the payment of all taxes with priority before the plan must be confirmed. Taxes classified as administration expense and involuntary gap must be paid in full with cash on the effective date of the plan. Employees' withholding taxes on wages granted third priority are to be paid in full with cash on the effective date of the plan or, if the class has accepted the plan, with deferred cash payments that have a value equal to the claims. Note that the third priority applies only to the employees' share. The employer's share (nontrust part) is a eighth priority. Claims for taxes granted eighth priority may be satisfied with deferred cash payment over a period not to exceed six years after the date of assessment of such claims; the value as of the effective date of the plan is equal to the allowed amount of the tax claims. These deferred payments include an amount for interest to cover the cost of not receiving payment as of the effective date of the plan. In *In re Burgess Wholesale Manufacturing Opticians, Inc.*,[278] the Seventh Circuit held that interest throughout the payment period had to be included in any deferred payment plan for taxes due the U.S. Government. The court did not rule on the rate of interest to be included. Because the 6-year time period is from the date of assessment, in many cases the taxes can be deferred for much less than 6 years after the effective date of the plan, due to an earlier assessment date.

The Bankruptcy Code does not state whether the I.R.C. interest rate, market rate, T-bill rate, or some other rate should be used. The rate that has been allowed has varied considerably. In *In re Hathaway Coffee House, Inc.*,[279] the

[275] *See Bilzerian v. United States*, 86 F.3d 1067 (11th Cir. 1996).
[276] *United States v. Frontone*, 2004 U.S. App. LEXIS 19002 (7th Cir. 2004).
[277] 703 F. Supp. 71 (D. Kan. 1988).
[278] 721 F.2d 1146 (7th Cir. 1984).
[279] 24 B.R. 534 (Bankr. S.D. Ohio 1982).

bankruptcy court held that the rate established under I.R.C. section 6621 was to be used. Other bankruptcy courts also initially accepted this rate. However, recent decisions tend to favor market rate. In *In re Southern States Motor Inns, Inc.,*[280] the Fifth Circuit rejected the I.R.C. section 6621 rate and accepted a rate based largely on expert testimony at the trial. In rejecting this rate, the court quoted the following from *Collier on Bankruptcy*.[281]

> The appropriate discount (interest) rate must be determined on the basis of the rate of interest, which is reasonable in light of the risks involved. Thus, in determining the discount (interest) rate, the court must consider the prevailing market rate for a loan of a term equal to the payout period, with due consideration of the quality of the security and the risk of subsequent default.

The court then noted that the I.R.C. section 6621 rate does not necessarily reflect the prevailing market rate and that the automatic application of section 6621 ignores the possibility of variation in the factors relevant to determining the appropriate interest rate. The court finally indicated that I.R.C. section 6621 was, at best, evidence of the prevailing market rate.[282] The rejection of the section 6621 rate in *Southern States* is consistent with some of the bankruptcy courts that have considered this question. In *In re Connecticut Aerosols, Inc.,*[283] the court held that, given two alternatives—the section 6621 rate and the rate under 28 U.S.C. section 1961(a) dealing with the interest rate on federal judgments—the latter was the best rate to use.

In *In re Richard Threlkeld et al.,*[284] the bankruptcy court rejected the government's assertion that the proper rate of interest on secured and unsecured tax claims is the rate specified in I.R.C. section 6621. The bankruptcy court cited *In re Camino Real Landscape Maint. Contractors, Inc.,*[285] where the Ninth Circuit stated "it is widely acknowledged . . . that the deferred payment interest rate of section 6621 serves deterrent and perhaps punitive, as well as economic purposes . . . [e]nforcement of such a statutory provision is outside the purposes of the Bankruptcy Code." The bankruptcy court then justified the use of relatively low rates of between 7 and 8.5 percent because of the relatively minor risk of nonpayment.

The district court allowed a bankruptcy judge's decision to permit a rate based on the effective rate being paid by 13-week Treasury bills to stand.[286] The Eighth Circuit reversed this decision and stated that the appropriate rate of interest is determined by reference to the prevailing market rate for a loan with a term equal to the payout period in the particular case, with due consideration to the existence and quality of any security and risk of subsequent default. The court did indicate that the I.R.C. section 6621 rate is relevant in determining the prevailing market rate. The court further held that the rate should be fixed as of

[280] 709 F.2d 647 (5th Cir. 1983), *cert. denied,* 465 U.S. 1022 (1984).
[281] paragraph 1129.03 (15th ed., 1982)
[282] *Supra* note 282.
[283] 31 B.R. 773 (Bankr. D. Conn. 1983), *aff'd,* 42 B.R. 706 (D. Conn. 1984).
[284] 1989 Bankr. LEXIS 1467 (Bankr. E.D. Cal. 1989).
[285] 818 F.2d 1503 (9th Cir. 1987).
[286] *In re Neal Pharmacal Co.*, 46 B.R. 721 (E.D. Mo. 1984).

Exhibit 11.1

Tax Provisions of Plan as Requested by IRS

1. *Claims Entitled to Priority Under Bankruptcy Code Section 507(a)(8).* These claims must be paid in full upon confirmation or within a reasonable period, not to exceed six years from the date of assessment shown on the proof of claim, and in a reasonable manner. If you wish to defer payment, you must pay us the present value of our claim. This means that you must pay interest at the rate set in Internal Revenue Code Sections 6601 and 6621, relating to interest on delinquent taxes.

2. *Secured Claims (Notice of Tax Lien Filed Prior to Bankruptcy).* These claims must be paid in full upon confirmation or paid in deferred payments over a reasonable period of time. If you choose to defer payments, you should provide the following in your plan:

(a) The United States should be paid at the present value of its claim. This means that you must pay interest at the rate set forth in paragraph 1, above.

(b) The United States should be paid over a reasonable period of time. What constitutes a reasonable period of time depends on the facts of each case.

(c) The United States should retain its Federal tax lien on the debtor's property until our claim is paid in full.

In addition, please note that a claim for penalties for which a notice of tax lien has been filed is treated as a secured claim. Also, the United States is entitled to post-petition interest as part of its claim to the extent that the debtor's equity in his property exceeds the amount of our secured claim.

3. *Unsecured Claims* (Claims for which no Notice of Tax Lien has been filed and which are not entitled to priority under Bankruptcy Code Section 507(a)(6)). These claims may be paid on the same basis as other unsecured claims provided that you have otherwise met the requirements of Chapter 11 of the Bankruptcy Code. Please note that accrued prepetition penalties for which no notice of tax lien has been filed are unsecured claims.

If your plan fails to provide for the payment of the Federal tax claims according to the terms set forth above, the United States will vote against the confirmation of the plan and/or object to the plan, which may cause unnecessary delays in the progress of the chapter 11 proceeding. If you wish to vary the terms of repayment from those set forth above, you must obtain our approval prior to confirmation.

The above discussion is in no way intended to be all-inclusive or a substitute for review of the bankruptcy law, nor is it intended to be an advanced acceptance of any plan, which appears to meet the above criteria. Each plan must be evaluated according to the facts involved in each particular case, and the United States reserves the right to reject and/or object to any plan where it deems such action to be in its best interests even though the plan appears to meet the above requirements.

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the effective date of the plan and not a floating rate.[287] In general, bankruptcy courts initially rejected the rate of I.R.C. section 6621.[288] However, other courts have approved this rate and the IRS recommends in its correspondence with the debtor (see Exhibit 11.1) that this rate be used. Thus, both the tax rate of I.R.C. section 6621 and the market rate are used in plans that provide for deferred tax payments. The issue regarding the appropriate rate to use is still somewhat unresolved. It is not as critical to the implementation of a plan as it was when overall interest rates were higher, but it does appear that the courts are moving toward the concept of prevailing market rate.

[287] 789 F.2d 1283 (8th Cir. 1986).

[288] *See In re Bay Area Services*, 26 B.R. 811 (Bankr. M.D. Fla. 1982); *In re Tacoma Recycling*, 23 B.R. 547 (Bankr. N.D. Wash. 1982). *See also In re Fisher*, 29 B.R. 542, 549 (Bankr. D. Kan. 1983).

A secured tax claim is not bound by the six-year period in section 1129(a)(9) of the Bankruptcy Code. In *In re Haas,*[289] the bankruptcy court confirmed a taxpayer's plan of reorganization over IRS objections that a 30-year payout period for a secured tax claim was too long.

The taxpayer, a 68-year-old sole practitioner, and his wife filed a chapter 11 petition. The IRS filed claims for $617,000 in secured tax liabilities, including $68,000 in nondischargeable employment trust fund taxes and $500,000 in dischargeable income taxes. The taxpayer's plan proposed allowing the IRS's secured claims to the extent of $259,000, which represented the value of property subject to tax liens. The secured claim would be bifurcated, with the $68,000 nondischargeable trust fund portion satisfied in cash out of the balance of an escrow account funded by deposits of a portion of the taxpayer's postpetition earnings. The plan proposed restructuring the balance of the secured tax debt, to be paid over a 30-year period, with interest.

To solve the problem raised by the IRS that the plan was not fair and equitable because, among other factors, the statute of limitations on collection would expire long before the end of the 30-year payout period, the court ordered as a condition of confirmation that the taxpayer and his wife execute all documents necessary to effect a waiver of the I.R.C. section 6502 collection period. On appeal, the Eleventh Circuit reversed the decision of the bankruptcy court, holding that a plan that required the payment of taxes over a period of 30 years, by an attorney who was 68, was infeasible.[290] The court noted that because the attorney was 68 at the time he commenced this appeal, he cannot be expected to practice law on a full-time basis for another 30 years. This fact alone dooms the plan as infeasible. The Eleventh Circuit also concluded that the plan impermissibly reclassifies the status of the IRS's claims. The U.S. district court affirmed a bankruptcy court's confirmation of a corporation's chapter 11 reorganization plan that did not give priority to a secured tax claim.[291]

TM Building Products Ltd.'s chapter 11 reorganization plan provided for TM to continue operating after plan confirmation and proceeds from accounts receivable and from the sale of some property were to be deposited into a separate account and distributed to creditors beginning 30 days after the plan's effective date. The plan provided for TM to pay the IRS's secured claim of $1.3 million when funds were available without adversely impacting TM's cash flow needs.

On appeal, the IRS argued that the payment schedule in the plan violated section 1129(a)(9)(C) because the tax claims listed as secured should have been listed as unsecured priority claims, entitled to full payment within six years from date of assessment. The district court rejected the argument of the IRS and held that section 1129(a)(9)(C) applies only to unsecured priority claims under section 507(a)(8). The court noted that because the IRS had secured its claim by filing prepetition tax liens, the tax claims were not unsecured.

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[289] 195 B.R. 933 (Bankr S.D. Ala. 1996).

[290] *In re Haas*, 162 F.3d 1087 (11th Cir. 1998).

[291] *United States v. TM Building Products Ltd.*, 231 B.R. 364 (S.D. Fla. 1998).

The district court also rejected the Service's assertion that the plan unfairly discriminates against its secured claims, in violation of section 1129(b)(2)(A)(i)(II), noting that the bankruptcy court found that reorganization would be preferable to liquidation. The bankruptcy court noted that liquidations can take years to consummate, whereas allowing TM to continue operating would probably allow for full payment in 3 to 4 years. The district court also noted that the bankruptcy court retained jurisdiction to review distributions to ensure that payments were in fact made when funds were available.

In *In re Thomas J. Rotella,*[292] the bankruptcy court allowed a secured debt to be paid over a period greater than 6 years from the date of assessment. The IRS objected to a chapter 11 plan where the secured part of a tax claim of $46,237 would be amortized over 30 years, and the unsecured priority portion would be paid in 6 equal annual payments. The bankruptcy court confirmed the chapter 11 plan over the objections of the IRS, but ordered that the interest rate paid to the IRS be changed to 9 percent from 8 percent as proposed in the plan (the interest paid to other creditors with secured claims against the taxpayer's residence, which was property in which the IRS had a lien).

The bankruptcy court held that the IRS must apply a check received from the taxpayers as provided for in the chapter 11 plan, even though the debtors had defaulted on that plan.[293] Citing *United States v. Energy Resources Co.*[294] the bankruptcy court noted that the question of whether a payment is voluntary or involuntary is irrelevant to payments made under a chapter 11 plan. The court concluded that a debtor's default on a chapter 11 plan does not cause the debtor's obligations to revert to their prepetition status.

However, the court held that an IRS levy on bank accounts was not a payment on the chapter 11 plan because the taxpayers at that time owed postconfirmation taxes and the levy clearly stated that it sought taxes due under the plan and postpetition taxes.

Other tax claims that do not qualify as tax priority items would receive treatment similar to that for other unsecured claims. Furthermore, the Reform Act[295] contained a provision that exempts bankruptcy proceedings from section 3466 of the Revised Statutes of the United States,[296] which provides that, in case of insolvency, debts due to the U.S. government must be satisfied before others are paid. This section does, however, continue to apply to common-law assignments for benefits of creditors and to equity receiverships under state laws. For secured tax claims, the claims must be paid in full on confirmation or paid in deferred payments over a reasonable period of time with the present value of the payments equal to the amount of the claim. Also, interest will be allowed to accrue during the proceedings to the extent that the value of the security exceeds the tax claims. The lien will be retained by the IRS until the claim is paid.

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[292] 1994 Bankr. LEXIS 436 (Bankr. N.D. N.Y. 1994).
[293] *In re Steeley*, 1996 Bankr. LEXIS 699 (Bankr. D. Idaho 1996).
[294] 495 U.S. 545 (1990).
[295] P.L. 95-598 § 322.
[296] 31 U.S.C. § 191.

The IRS recommends in most cases that the government oppose a plan unless it provides for the items mentioned in Exhibit 11.1. If a case contains provisions that differ from these, it may be advisable to contact a bankruptcy advisor in the IRS Special Procedures Function and explain why the specific proposals are inappropriate or should be structured differently. The IRS in the Southern and Central Districts of California recommends the following language for plan treatment of IRS priority claims where the debtor is not an individual:

> Class (or unclassified priority tax creditors) shall be paid on account of their claims, deferred cash payments, commencing on the effective date of the plan and monthly thereafter for a period not exceeding six years from the date of assessment, of a value, as of the effective date of the plan, equal to the allowed amount of such claims. Such monthly payments shall include interest at the rate provided by 26 USC 6621, and/or California Revenue and Taxation Code Section 19269, and shall retain unaltered any liens that existed on the petition date to secure payment of the claims.

The Eleventh Circuit, reversing the district court and bankruptcy court, has ordered the payment of unclaimed funds in a bankruptcy case be returned to the debtor, not to the United States Treasury, pursuant to 28 U.S.C. section 2042.[297]

Georgian Villa Inc. (GVI) was a not-for-profit corporation that built and operated a hospital that filed a chapter 11 bankruptcy protection in 1977. After the hospital property was sold and its debts, including administrative expenses, were paid, the surplus of $300,000 was left in the registry of the bankruptcy court. The corporation remained dormant until 1992, when it moved to reopen the case and sought to have the balance of the unclaimed surplus returned to the corporation, pursuant to 28 U.S.C. section 2042 (1988). The bankruptcy court denied the motion for payment and ordered the unclaimed funds to be paid to the U.S. Treasury because the corporation, although it remained in good standing as a corporation, was no longer a viable corporation because it had lain dormant. The district court affirmed.

The Eleventh Circuit court noted that the whole purpose of the bankruptcy system is to make the bankrupt's property available to creditors and to give any surplus back to the debtor. In noting that the bankruptcy court's decision was clearly erroneous, the Circuit Court stated that "the exercise of the bankruptcy court's equitable power to disregard the corporate entity is appropriate only where the corporate debtor is no longer in existence," and noted that the corporation's dormancy during its bankruptcy proceedings did not mean that it was no longer a viable entity and as such no longer entitled to its surplus funds.

(n) Dismissal of Bankruptcy Petition

One justification of dismissal of a chapter 11 petition is that the petition was filed solely for tax intent. The district court reversed a bankruptcy court's dismissal of a woman's chapter 11 case, rejecting the lower court's finding that the woman was attempting to avoid her tax liabilities.[298]

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[297] *Georgian Villa Inc. v. United States*, 55 F.3d 1561 (11th Cir. 1995).
[298] *In re Cohen*, 191 B.R. 482 (S.D. Fla. 1995).

A U.S. district court has held that a bankruptcy court did not clearly err in dismissing a couple's chapter 11 proceeding based on their failure to pay post-petition income taxes while operating their farm as debtors, in, possession.[299] The court noted that the failure of a debtor-in-possession to pay postpetition taxes has been held to constitute cause for conversion or dismissal.

(o) Chapter 12 and Chapter 13 Adjustments

Some provisions that apply to chapter 12 and chapter 13 proceedings are similar to Bankruptcy Code section 1129 (chapter 11 reorganization), which requires that priority items be provided for in the plan. Section 1322 (for chapter 13) and section 1222 (for chapter 12) of the Bankruptcy Code state that the plan must provide for the full payment, in deferred cash payments, of all claims entitled to priority under Bankruptcy Code section 507(a)(8), unless the holder of a claim agrees to different treatment. Thus, all taxes with priority will be paid in full. In another chapter 13 case, *In re Chukwuemeka M. Ekeke,*[300] the bankruptcy court dismissed the case because the plan failed to provide for 100 percent payment of a priority tax claim. Note that no interest is to be paid on these claims; it is not necessary that the present value of the future payments equal the claim, but only that the total future payments equal the debt. For example, in *In re Elmer E. Palmer,*[301] the court ruled that no provision under chapter 13 refers to the government's right to receive the time value of money. In *In re Allan Wayne Hieb,*[302] the chapter 13 plan provided for the payment of $16,642 of unsecured priority tax claims over 63 months. The IRS claimed that it was entitled to present value payments on the principal amount, as if a chapter 7 liquidation were taking place. The court held that payment for interest is not required under section 1322(a)(2) of the Bankruptcy Code. However, interest would be required under section 1325(a)(4) if the IRS would receive 100 percent from a chapter 7 liquidation, which was not the case here.

Because the chapter 12 confirmation requirements are similar to those of chapter 13, interest would most likely not be included in priority tax payments in a chapter 12 case. In chapter 11 proceedings, the present value of future payments is compared with the value of the claim.

Section 1322 of the Bankruptcy Code provides that the time period for future payments must not exceed 3 years, unless the court approves a longer period, and in no case will the period exceed 5 years. A similar provision applies for chapter 12 cases except that the payment period may be longer under two exceptions:

1. Section 1222(b)(5) of the Bankruptcy Code allows longer payments for unsecured and secured claims where the plan provides for the curing of defaults and payments are made while the case is pending.

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[299] *In re Berryhill*, 189 B.R. 463 (N.D. Ind. 1995).

[300] 1990 Bankr. LEXIS 2926 (Bankr. S.D. Ill. 1990), *aff'd,* 133 B.R. 450 (Bankr. S.D. Ill. 1991).

[301] 86-2 USTC (CCH) ¶ 9592 (D.C. Tex. 1986).

[302] 88 B.R. 1019 (Bankr. D.S.D. 1988). *See In re Hardy*, 755 F.2d 75 (6th Cir. 1985) and *In re Hansen*, 77 B.R. 722 (Bankr. D. N.D. 1987) (chapter 12).

2. A secured claim may be paid over a period longer than the 3- to 5-year plan period if one of the following conditions is satisfied:
   - **A.** The holder of the claim accepts the plan.
   - **B.** The holder of the claim retains the lien securing the claim, and the value of the payments or property to be distributed as of the effective date of the plan is not less than the amount of the claim.
   - **C.** The debtor surrenders the property to the creditor.

In *In re David Brian Burgess,*[303] the bankruptcy court allowed a tax allocation made by the IRS to stand in a chapter 13 case. The IRS held a secured interest in property that had a value less than the amount of the claim for taxes, interest, and penalties. The IRS apportioned its claim to the collateral pursuant to its tax lien by applying the tax, interest, and penalty from 1988 first and then apportioning the remaining collateral to tax and interest for 1989. As a result of this process, part of the payment was allocated to cover penalties. The debtor objected on the basis that the IRS lien should first secure the payment of all taxes, the remaining taxes and all interest should be an unsecured priority claim, and all penalties should be treated as an unsecured general claim.

The bankruptcy court held that the IRS acted within its discretion in apportioning its claim to the debtor's collateral. The court rejected the application of *United States v. Energy Resources Co.,*[304] noting that the Supreme Court merely held that a bankruptcy court has the equitable power to direct how the IRS applies the debtor's payment if it is necessary for the success of a plan of reorganization and cannot be applied to allow the apportioning of tax liabilities from secured to unsecured in order to discharge a larger portion of the liability.

The bankruptcy court refused to allow a couple to become charitable after filing bankruptcy.[305] The Smihulas filed a chapter 13 petition scheduling approximately $61,000 of unsecured consumer debt. Their chapter 13 petition plan provided for monthly payments of $865 to their creditors. The Smihulas then tried to convert their chapter 13 case to chapter 7 and changed their plan to reflect a new $700 monthly charitable contribution in place of payments to creditors.

The bankruptcy court held that because the Smihulas' charitable giving began after they filed for bankruptcy, the court had the authority to deny chapter 7 relief. The court, in considering the following statutory language of section 707(b), as amended by the Religious Liberty Act, "the court may not take into consideration whether a debtor has made, or continues to make, charitable contributions," concluded by examining legislative history that "the amendment was not intended to allow debtors to begin making charitable contributions on the eve of bankruptcy."

The taxpayer filed a chapter 13 petition in 1997 and scheduled $34,500 of unpaid 1988 taxes jointly owed with his wife who did not file for bankruptcy.[306]

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[303] 171 B.R. 227 (Bankr. E.D. Tex. 1993).

[304] 495 U.S. 545 (1990).

[305] *In re James A. Smihula*, et ux., No. 98-13949 (Bankr. D.R.I. May 24, 1999).

[306] *In re Westberry*, 1998 U.S. Dist. LEXIS 18536; 98-2 U.S. Tax Cas. (CCH) P50,883; 82 A.F.T.R.2d (RIA) 7232 (M.D. Tenn. 1998); *aff'd*. 215 F.3d 589 (6th Cir. 2000).

The IRS began its collection of the tax by levying her wages. The bankruptcy court granted the motion made by the husband for the enforcement of the codebtor stay under section 1301. The bankruptcy court concluded that because Wilbur's 1988 income was used exclusively for household purposes, the resulting tax indebtedness qualified as consumer debt under the profit-motive test.

On appeal, the district court reversed holding that federal income and self-employment taxes are involuntarily imposed and, thus, are not incurred for a personal, family, or household purpose under sections 101(8) and 1301 of the Bankruptcy Code. The court also noted that federal tax liability results from earning money, not through consumption.

The taxpayer scheduled an unsecured IRS claim for $338,000. The Service filed a proof of claim—agreeing with the fact that the claim was unsecured—for $461,000, asserting that the claim was a priority claim. The bankruptcy court concluded that the taxpayer's tax claim exceeded $250,000 and that it was noncontingent and liquidated.[307] Citing *In re Mazzeo,*[308] the court stated that a section 6672 "responsible person" penalty is not contingent merely because the individual disputes it. The court also held that the claim was liquidated because its value was easily ascertainable and exceeded $250,000. The court explained that the existence of a dispute, without more, is insufficient to render a tax claim unliquidated.

The district court, affirming a bankruptcy court decision, held that a debtor's confirmed chapter 12 plan and order discharging the IRS's secured tax lien is final because the IRS had notice of the plan and failed to object to it.[309]

(p) Impact of Plan on Tax Liability

In *In re Frank Todd,*[310] the bankruptcy court held that the IRS does not have an unsecured claim if it fails to timely object to an improper plan. The bankruptcy court confirmed a chapter 13 plan that provided for the surrender of a parcel of real property to its three lienholders, which included the IRS, in settlement of all obligations. The IRS did not object to the plan when it was confirmed. Later, the IRS claimed that it had an unsecured claim for that portion of the tax deficiency not satisfied by the property sold. The court concluded that even though the bankruptcy plan was improper under Bankruptcy Rule 3007, the government was bound by the plan because it failed to timely object.

In *In re DePaolo,*[311] the district court held that when the IRS fails to object to a reorganization plan, it is barred from asserting additional liability. Hugh DePaolo filed a chapter 11 petition and subsequently filed a plan of reorganization that provided for the payment in full of the IRS's income tax claim for the 1986 and 1987 tax years in monthly installments over the course of 6 years. The IRS

[307] *In re Berenato*, 226 B.R. 819 (Bankr. E.D. Pa. Oct. 29, 1998).
[308] 131 F.3d 295 (2d Cir. 1997).
[309] *In re Howard J. Black*, 2000 U.S. Dist. LEXIS 5880 (D. Az. 2000).
[310] 1988 Bankr. LEXIS 2473 (Bankr. N.D. Cal. 1988).
[311] 165 B.R. 491 (D. Wyo 1994).

filed four proofs of claim with respect to its 1986 claim, and indicated that the claim was for $26,724.

The IRS did not object to the reorganization plan and did not appeal the confirmation of the plan. After confirmation, the IRS filed amended proofs of claim reflecting payments received under the plan. In October 1989, the bankruptcy court entered its final decree and ordered the case closed. Subsequently, the IRS completed an audit and issued DePaolo a deficiency notice, asserting additional taxes for 1986 as well as penalties for subsequent years. The government attempted to increase the amount of the 1986 tax claim to $38,725.

DePaolo instituted an adversary proceeding against the IRS and sought a declaratory judgment that the increased tax claims for 1986 and 1987 were barred by *res judicata* and estoppel. The bankruptcy court granted the IRS summary judgment because the tax at issue was a new tax that had not been previously treated under the debtor's confirmed chapter 11 plan. DePaolo appealed. The district court reversed the bankruptcy court's decision and held that the government's claim was barred by *res judicata.* The district court rejected the government's contention that the confirmation of DePaolo's plan was not a final judgment on the merits, noting that the IRS had actively participated in the bankruptcy proceedings, had not objected to the reorganization plan, and had not appealed the bankruptcy court's confirmation of the plan.

The Tenth Circuit reversed on the basis because the tax at issue was new tax that had not previously treated under the debtor's plan. Additionally, the Tenth Circuit held that the confirmation did not fix nondischargeable tax liabilities.[312]

In *Grogan v. Commissioner,*[313] Grogan objected when the IRS filed a proof of claim after the plan confirmation hearing but before the bar date; the claim was much larger than the amount provided for in the plan. Grogan argued that confirmation of the chapter 13 plan, to which the IRS did not object, bound the IRS to the amounts listed in the plan.

The bankruptcy court overruled Grogan's objections by holding that the IRS was not bound by the amounts listed in the confirmed plan. The court noted that the claims bar date is often scheduled after the date of confirmation, and that, if a debtor wants to ensure the finality of the confirmation order, the debtor can (1) make adequate provision in the plan for creditors with priority claims or (2) file a claim on behalf of a creditor. The court concluded that to limit the IRS to an amount determined solely by the debtor while the time to file proofs of claims had not yet expired would violate fundamental principles of bankruptcy claims practice.

In *Frank Thompson v. United States,*[314] the district court ruled on a similar issue. The IRS filed a proof of claim in a bankruptcy case, including a $59,200 priority unsecured claim for employment taxes. Frank Thompson proposed a plan stating that the IRS's unsecured priority claim would be paid in full and that the unsecured claim would be treated in a class with other nonpriority unsecured claims that were impaired. The plan was subsequently modified to

[312] *In re Depaolo*, 45 F.3d 373 (10th Cir. 1995).
[313] 158 B.R. 197 (Bankr. E.D. Cal. 1993).
[314] 1993 U.S. Dist. LEXIS 12384 (S.D. Tex. 1993).

eliminate the IRS's unsecured claim. The notice of modification, which was sent to the IRS, did not mention the modification that would eliminate the unsecured claim. The IRS did not object and the court confirmed the plan.

Thompson then attempted to reduce the claims of the IRS based on the terms of the plan, arguing that the IRS should be barred from challenging the plan, the modification, or the confirmation order because the IRS never filed an objection. The court ruled Thompson's modification was inadequate because the IRS did not receive adequate notice.

The district court affirmed. The court found that the notice of modification was misleading and, as a result, the IRS did not receive adequate notice. The court explained that, under section 502(a) of the Bankruptcy Code, a claim is deemed allowed unless an objection is filed. No objection was filed by Thompson until after the plan was confirmed.

In *In re Austin,*[315] the bankruptcy court held that the IRS must wait, along with other creditors, for plan distribution. Donald Austin filed a chapter 11 petition and was held to be the responsible person for unpaid payroll taxes owed by Diamond Manufacturing Co. and Rose Marine Inc., both chapter 7 debtors. The IRS filed an administrative claim in Austin's case for $443,000 in postpetition taxes, and moved for immediate payment of the claim under section 503 of the Bankruptcy Code.

Austin and Signet Credit Corporation objected, indicating that they had proposed a competing plan providing for payment of administrative claims in full. Austin argued that the government should be required to look to the chapter 7 estates of Diamond and Rose first. Signet objected to the government being paid before everyone else while a valid plan was pending.

The bankruptcy court rejected the IRS's motion, explaining that sufficient funds seemed to exist in Austin's bankruptcy estate to pay administrative claims. The court indicated that the IRS would not be prejudiced by waiting, along with other creditors, for an orderly distribution to be made pursuant to a confirmed plan of reorganization.

The court failed to accept the government's argument that it had effectively financed the debtor's operations since 1985. The bankruptcy court explained that Austin's liability was derivative, and until the possibility and result of some payment on the IRS's claim by Diamond and Rose was resolved, it was not inequitable to require all parties to wait for payment until a plan of reorganization was confirmed.

(q) Taxes on Liquidation Sales

The Supreme Court, in *In re China Peak Resort,*[316] upheld the authority of the states to impose a sales or use tax on a bankruptcy liquidation. This decision reverses the results of a 32-year-old Ninth Circuit case referred to as "*Goggin II,*"[317] which prohibited a tax on a liquidation sale.

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[315] 94-1 USTC (CCH) ¶ 50,255 (Bankr. S.D. Ga. 1994).

[316] 490 U.S. 844 (1989).

[317] *California State Board of Equalization v. Goggin*, 245 F.2d 44 (9th Cir.), *cert. denied*, 353 U.S. 961 (1957).

The Court concluded that, "whatever immunity the bankruptcy estate once enjoyed from taxation on its operations has long since eroded and . . . there is now no constitutional impediment to the imposition of a sales tax or use tax on a liquidation sale."

§ 11.3 TAX DISCHARGE

(a) Introduction

The extent to which a tax is discharged depends on (1) whether the debtor is an individual or a corporation, (2) the chapter under which the petition is filed, and (3) the nature and priority of the tax.

The discharge ability of tax fines and penalties and interest depends on the nature of the tax to which penalties and interest relate. If the tax is nondischargeable, interest and penalties will not be discharged.[318] The converse is also true. The bankruptcy court has original, but not exclusive, jurisdiction to determine the dischargeability of tax claims.[319]

(b) Individual Debtors

Section 523(a) of the Bankruptcy Code provides that in a chapter 7 or chapter 11 proceeding involving an individual debt, all taxes that are entitled to priority are exempt from a discharge. Also exempt from discharge are prepetition taxes due for a period when the debtor failed to file a return, filed the return late and it was filed less than 2 years before the petition date, or filed a fraudulent return or willfully attempted in any manner to evade or defeat the tax due. When fraud is involved, the court may hold that the tax claim is nondischargeable.[320] Any tax due that relates to failure to file a return or to other misconduct of the debtor will be considered nondischargeable if such tax qualifies for priority under Bankruptcy Code section 507. Some question exists as to whether a return filed late due to a reasonable cause would be considered nondischargeable. Section 523(a)(3) of the Bankruptcy Code provides that a claim that is not listed nor scheduled in time to permit the filing of a proof of claim will not be discharged unless the debtor had notice or actual knowledge of the case in time to file the proof of claim. A tax return filed by the IRS does not satisfy the return requirements for determining dischargeability of taxes. In *Robert G. Gushue*,[321] in 1982, the IRS filed substitute returns on behalf of the taxpayer, for 1975–1978. The taxpayer contested the determination of the taxes in Tax Court and then later settled with the IRS. The taxpayer subsequently filed a bankruptcy petition.

Section 523(a) of the Bankruptcy Code provides that a tax that has priority in a chapter 7 and 11 case may not be discharged. In *In re Doerge*,[322] the debtor did

[318] 11 U.S.C. § 523(a)(1)(7).
[319] 28 U.S.C. § 1471.
[320] *See Thomas V. Cassidy*, 87-1 USTC (CCH) ¶ 9225, 892 F.2d 637 (7th Cir. 1987); *cert. denied,* 111 S. Ct. 48 (1990).
[321] 126 B.R. 202 (Bankr. E.D. Pa. 1991).
[322] 181 B.R. 358 (Bankr. S.D. Ill. 1995).

not raise the statute of limitations defense in his tax court petition. Under Tax Court Rule 34(b)(4), the court noted "the failure to include this contention of error in his petition constituted a waiver for purposes of the tax court litigation."[323] The court noted that because the debtor did not raise this defense, it appears that he intended to waive the issue of expiration of the statute of limitations and, therefore, foreclose it from further litigation.

Based on the fact that the taxpayer failed to raise the issue of statute of limitations and that the debtor's 1981 taxes contained a stipulation in which the debtor agreed to waive the statutory restrictions that prohibited assessment and collection of the tax deficiency until the decision had become final, the court concludes that the equitable doctrine of estoppel precludes the debtor from changing his position in this action to defeat the government's claim of nondischargeability of the 1981 taxes. Thus the court concluded that the debtor's 1981 tax liability was still assessable at the time of the filing of the bankruptcy petition and is thus nondischargeable as a priority tax under section 523(a)(1)(A) and section 507(a)(8)(A)(iii) of the Bankruptcy Code.

In a footnote, the court noted that in *Levinson v. United States*,[324] the Seventh Circuit set forth certain boundaries on the applicability of judicial estoppel: The litigant's later position must be clearly inconsistent with his earlier position, the facts at issue must be the same in both cases, and the party to be estopped must have been successful in convincing the court of his position in the earlier proceeding. The court noted that the "last requirement is not technically met in this case even though the court's decision incorporated the debtor's stipulation agreeing to immediate assessment, because the debtor could not have convinced the court of a position he did not raise."

The district court held that postpetition interest accruing on a secured IRS claim for employment taxes is not exempt from discharge under Bankruptcy Code section 507(a)(8). The taxpayers commenced separate chapter 11 proceedings, and the IRS filed secured claims in each case.[325]

The taxpayers claimed that postpetition, preconfirmation interest on the secured claims was dischargeable. The district court rejected the government's argument that sections 523(a) and 507(a)(8) of the Bankruptcy Code exempt postpetition interest from discharge because the claim for interest relates to employment taxes of a kind specified in sections 507(a)(8)(C) or (D). The district court noted that the IRS ignored the limiting word "unsecured" in section 507(a)(8) and that because the claim for postpetition interest is asserted as a secured claim, rather than an unsecured claim, it is not of the kind specified in section 507(a)(8).

The bankruptcy court held that the tax liabilities for 1975 through 1978 were not dischargeable because Gushue failed to file returns. The court rejected the

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[323] *See Shedd's Estate v. Commissioner*, 320 F.2d 638, 640 (9th Cir. 1963); *Given v. Commissioner*, 238 F.2d 579, 583 (8th Cir. 1956); *Matheson v. Commissioner*, 1993 U.S. App. LEXIS 12704 (9th Cir. 1993).

[324] 969 F.2d 260, 264-65 (7th Cir. 1992).

[325] *In re Victor*, 211 B.R. 62 (D. Utah 1996), *aff'd*, 80 A.F.T.R.2d (IRA) ¶ 97-5124 (10th Cir. 1997).

taxpayer's argument that the substitute returns filed by the IRS were returns for the purposes of I.R.C. section 6020(a) and section 525 of the Bankruptcy Code dealing with taxes that are nondischargeable.

The court distinguished *Carapella v. United States*[326] and Rev. Rul. 74-203 because the taxpayer never executed a Form 870 and did not sign the substitute returns.

(i) Failure to File Tax Returns

In order for an individual to be discharged from a tax, a tax return must have been filed, according to section 523(a)(1)(B) of the Bankruptcy Code.

In *Douglas W. Bergstrom v. United States*,[327] the Tenth Circuit held that substitute returns are not filed returns for purposes of discharge of tax requirements.

Douglas Bergstrom failed to file income tax returns for the years 1979 through 1981, and the IRS prepared substitute returns that were filed by February 8, 1984. The returns reflected the tax liability based on information from Forms W-2 and 1099 and did not include any deductions. The IRS then issued a deficiency notice to the taxpayer for all three years. Bergstrom filed a chapter 7 bankruptcy petition in November 1988.

The Tenth Circuit held that the taxes due on the substitute returns were nondischargeable because the substitute returns do not constitute filed returns under I.R.C. section 6020(a) without the signature of the taxpayer.

The Tenth Circuit, citing *In re Roberts*,[328] held that the tax penalties were dischargeable under section 523(a)(7)(B) because the penalties were imposed on an event that occurred more than 3 years before the filing of the bankruptcy petition.

The bankruptcy court held, in *John Arenson v. United States*,[329] that the tax claims from amended returns filed to challenge the IRS's determination of tax liability are not tax returns for purpose of determining the dischargeability of taxes under section 523(a)(1)(B)(1) of the Bankruptcy Code. The court noted that the taxpayer's failure to file returns precluded discharge and that the amended returns were filed only after the IRS had determined Arenson's tax liability and for the purpose of challenging the IRS's determination of the tax.

Tax returns filed by tax protesters are not considered tax returns for purposes of section 523(a)(1)(B) of the Bankruptcy Code. The tax is not dischargeable even though the return was filed more than 2 years prior to bankruptcy and the tax return was due more than 3 years prior to bankruptcy.[330]

In *In re Rank*,[331] the bankruptcy court held a substitute return filed by the IRS did not satisfy the requirements of I.R.C. section 6020(b) and as a result was not considered as a filed return. The court concluded that, because the return was considered as not being filed, the taxes were not discharged.

[326] 84 B.R. 779 (Bankr. M.D. Fla. 1988).
[327] 949 F.2d 341 (10th Cir. 1991).
[328] 906 F.2d 1440 (10th Cir. 1990).
[329] 134 B.R. 934 (Bankr. D. Nebr. 1991); *aff'd*, 145 B.R. 310 (D. Nebr. 1992).
[330] *In re Slater*, 96 B.R. 867 (Bankr. C.D. Ill. 1989).
[331] 161 B.R. 406 (Bankr. N.D. Ohio 1993).

In *In re Gushue,*[332] the bankruptcy court ruled that a stipulated settlement executed by the debtor in Tax Court did not satisfy the requirements for a return because the debtor had been uncooperative with the IRS.

Although most courts have held that substitute, or dummy, returns prepared by the IRS do not constitute returns for purposes of the chapter 7 discharge provision, some have found ways to consider them returns.

In *In re Elmore,*[333] the returns filed by the IRS qualified as returns under section 523 of the Bankruptcy Code. The IRS prepared substitute returns for Ivo Thomas Elmore, in July 1987, for his 1981, 1982, and 1983 tax years. The IRS issued a deficiency notice to Elmore for the taxes plus interest and penalties. Elmore filed a Tax Court petition. The Tax Court was settled, in September 1988, with an order that held Elmore liable for unpaid federal income taxes, interest, and penalties for the 3 years at issue.

In October 1992, Elmore filed a bankruptcy petition. In July 1993, he filed an adversary proceeding to determine the dischargeability of his 1981, 1982, and 1983 federal income taxes. The government argued that Elmore's taxes were nondischargeable under section 523 of the Bankruptcy Code because Elmore had failed to file the returns. Elmore argued that the returns were filed in the Tax Court action and that, as such, they were filed for section 523 purposes.

The bankruptcy court held that the returns filed as part of Elmore's Tax Court petition constituted a filing sufficient to remove them from the exceptions from discharge under section 523(a)(1)(B)(i) of the Bankruptcy Code. The court noted that Elmore had provided the government with a completed Form 1040 for each of the taxable years at issue and had supplied any remaining information needed by the IRS to determine his income and deductions.

Also, in *In re Carapella,*[334] the court ruled that a Form 870 waiver of restrictions on assessment, executed by the debtor in cooperation with the IRS, satisfied the requirements of section 523(a)(1)(B)(i) of the Bankruptcy Code. In *In re Lowrie,*[335] the bankruptcy court distinguished this case from most others because the taxpayer was cooperative: she signed a form containing sufficient information to calculate her tax liability, and she admitted owing the taxes.

Several courts have examined the issue of the extent to which a return filed after the taxes were assessed should be considered a "return" under section 523 of the Bankruptcy Code. Several of the recent cases are examined here.

The Sixth Circuit reversed a district court decision granting a debtor summary judgment on the dischargeability of taxes, holding that the debtor's Forms 1040, filed after the IRS prepared substitute returns and made assessments, were not "returns" under 11 U.S.C. section 523(a)(1)(B).[336] In 1990, the Service prepared substitute returns and issued deficiency notices because the taxpayer failed to timely file his 1985–1988 income tax returns. After the IRS assessed

[332] 126 B.R. 202 (Bankr. E.D. Pa. 1991).
[333] 165 B.R. 35 (Bankr. S.D. Ind. 1994).
[334] 84 B.R. 779 (Bankr. M.D. Fla. 1988).
[335] 162 B.R. 864 (Bankr. D. Nev. 1994).
[336] *In re Hindenlang*, 164 F.3d 1029 (6th Cir. 1999); *cert. denied* 528 U.S. 810 (1999).

taxes based on the substitute returns in 1993, the taxpayer filed income tax returns that were substantially the same as the substitute returns.

The Sixth Circuit held that a tax return filed after a deficiency assessment no longer qualifies as a "return" under section 523(a)(1)(B). The Circuit Court noted that in order for a document to qualify as a return: "(1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law."[337] This test was derived from two Supreme Court cases.

The Sixth Circuit concluded that a Form 1040 filed too late is not a return because it ceases to serve any tax purpose and has no effect under the I.R.C. A purported return that has no effect under the Code cannot constitute an honest and reasonable attempt to satisfy the requirements of the tax law, which is the fourth requirement of *Beard v. Commissioner.* The Sixth Circuit concluded that if a document purporting to be a tax return serves no purpose at all under the I.R.C., such a document cannot, as a matter of law, qualify as an honest and reasonable attempt to satisfy the requirements of the tax law. Accordingly, the document was held not be a "return" for purposes of section 523(a)(1)(B) of the Bankruptcy Code.

The Sixth Circuit acknowledged that it did not address the issue of a "return" if the return showed additional tax. However, in a footnote, the Sixth Circuit stated: "We do not conclude that were *Hindenlang* able to show a tax purpose for filing a Form 1040 after the IRS has made an assessment, he would automatically satisfy the fourth prong of the Beard test. The government could still produce particularized evidence showing that such a late filing of a Form 1040 was neither an honest nor reasonable attempt to comply with the tax law. We save resolution of that hypothetical case for another day."

The Fourth Circuit also held that tax returns filed after an assessment based on substitute returns are not valid returns.[338]

A bankruptcy court held that a return filed as a result of an IRS Amnesty Program constituted a return even though filed after the tax had been assessed because the filing of the return constituted an honest and reasonable attempt by the debtor to satisfy the tax law by complying with the provisions of the amnesty program.[339]

The bankruptcy court held that Forms 1040 a debtor filed after the IRS had assessed taxes for those years were not "returns" under 11 U.S.C. section 523(a)(1)(B)(i) and, thus, those taxes were not dischargeable.[340]

John Pierchoski did not file timely tax returns for 1983–1989. The IRS determined deficiencies, and the deficiencies were challenged by Pierchoski in the Tax Court, which eventually entered a stipulated decision. The IRS then

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[337] *Germantown Trust Co. v. Commissioner*, 309 U.S. 304, 84 L. Ed. 770, 60 S. Ct. 566 (1940), and *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 79 L. Ed. 264, 55 S. Ct. 127 (1934). *Summarized in Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986).

[338] *In re Moroney*, 352 F.3d 902 (4th Cir. 2003).

[339] *In re Klein*, No. 98-13391-BKC-RAM (Bankr. S.D. Fla. 2003).

[340] *In re Pierchoski*, 243 B.R. 639 (Bankr. W.D. Pa. 1999).

assessed the stipulated amounts in September 1993. In the following month, Pierchoski submitted Forms 1040 for each year, reporting the total amount of tax due, the amount of tax withheld, payments made, and the amount owed, all reflecting the stipulations.

More than two years later, Pierchoski filed for bankruptcy, listing the IRS as the only creditor. After he received a discharge and his case was closed, the IRS began levying Pierchoski's assets in an attempt to collect the 1983–1989 assessments. After having his bankruptcy case reopened, Pierchoski requested a determination that his tax debts had been discharged. The IRS argued that the debts were nondischargeable because Pierchoski had not filed "returns." The bankruptcy court held that the debts were dischargeable.

On appeal, the district court reversed based on the Sixth Circuit's intervening decision in *In re Hindenlang,* and remanded for a determination of whether Pierchoski's post-assessment Forms 1040 had any tax effect under the I.R.C.

Citing the Sixth Circuit decision in *Hindenlang,* the bankruptcy court concluded that Forms 1040 served no tax-related purpose and had no effect under the tax laws. The court noted that allowing the debtor's belated filings to qualify as returns would create an inconsistency in that late filings can result in civil and criminal tax penalties but a taxpayer filing for bankruptcy would be able to have the underlying tax liability discharged.

The Ninth Circuit Bankruptcy Appeals Panel, also looking at the issue of what is a return, agreed with the bankruptcy court that held that the debtor's Forms were tax returns.[341] The taxpayer failed to file income tax returns and the IRS prepared substitute returns based on its determinations of the debtor's income and deductions and assessed the taxes it determined were owed. Subsequently, the debtor submitted Forms 1040 ("Forms") to the IRS for the subject years. The Forms reflected the same wage income as the substitute returns previously made by the IRS.

The debtor made an Offer of Compromise but it was rejected on procedural grounds, apparently regarding whether an original or photocopy was supplied to the IRS. A second Offer of Compromise was made. The debtor asserts the IRS did not respond to that offer. The debtor provided the bankruptcy court a declaration stating that he decided to file returns in response to an amnesty program offered by the IRS and had consulted both an attorney and an accountant to prepare the taxes. All of the forms in question contained a preparer's signature.

The IRS made two arguments that were both rejected by the appeal panel. The first one was that "once the IRS makes an involuntary assessment against a non-filing taxpayer, such as the debtor here, the taxpayer cannot claim that he has filed a return simply by tendering a standard form that reflects the IRS's prior determinations."

The panel held that section 523(a)(1)(B) can be satisfied, even after substitute returns are prepared by the IRS and an assessment is made, if the debtor cooperates with the IRS and takes actions that amount to adopting the substitute returns.

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[341] *In re Nunez*, 232 B.R. 778 (9th Cir. BAP 1998).

The second argument made by the IRS was that the forms were not returns because they did not constitute an honest and reasonable attempt by the debtor to satisfy the tax laws. The Ninth Circuit BAP noted that the bankruptcy court examined the issue of whether the debtor made an honest and reasonable attempt to satisfy the tax requirements, and concluded that there was no evidence that the debtor "did something wrong under that prong of the test." The court rejected the argument that the mere passage of time could support a finding of bad faith, stating that Congress could have included such a time limit if it had wanted to.

In a similar case, the Ninth Circuit BAP held that the IRS's preparation of the substitute return and Hatton's cooperation with the government in executing the installment agreement effectively resulted in Hatton's filing of a tax "return" as defined by section 523(a)(1)(B)(i). However, the Ninth Circuit reversed the BAP, noting that while chapter 7 debtors are discharged from personal liability for all debts, including unpaid taxes, incurred before filing, section 523 excepts from discharge a tax liability debt where the debtor failed to file the required tax return.[342]

The Ninth Circuit concluded that because the term "return" is defined by neither the Bankruptcy Code nor the Internal Revenue Code, there is no statutory definition of the term. The Ninth Circuit relied on the four-factor test set out in *Beard v. Commissioner*,[343] to determine whether the installment agreement and substitute return amounted to the filing of a return under section 523. The Ninth Circuit held that the agreement and substitute return did not qualify as a return under *Beard* because neither was signed under the penalty of perjury and because neither document represented an honest and reasonable attempt to satisfy the requirements of tax law. Hatton, according to the Ninth Circuit, made every attempt to avoid paying his taxes until collection by the IRS became inevitable and as a result, the Ninth Circuit concluded that because Hatton's tax liability for the 1983 tax year resulted from his failure to file a return under section 523, his liability was not dischargeable in bankruptcy.

Eventually the debtor entered into an installment payment agreement. The Ninth Circuit BAP held that the substitute returns, when taken along with the signed installment agreement, qualified as returns for purposes of Section 523(a)(1)(B). Under *Hatton,* then, the preparation of substitute returns and assessment by the IRS does not act as a complete bar to efforts by the Debtor to file a return.

In *In re Mickens,*[344] the district court agreed with the IRS that where a document is a legal nullity it cannot satisfy the definition of a return. The court noted that Form 1040 filed by the debtor after the IRS had already prepared a substitute return and assessed the tax liability had no legal effect. The court noted that Form 1040 did not allow tax liability to be assessed, it did not affect the amount of the tax liability, it did not trigger the assessment time period under the I.R.C., or affect the delinquency time period for purposes of calculating civil penalties,

[342] *In re Hatton,* 220 F.3d 1057 (9th Cir. 2000).
[343] 82 T.C. 766 (1984), *aff'd* 793 F.2d 139 (6th Cir. 1986).
[344] 215 B.R. 693 (Bankr. N.D. Ohio 1997), *aff'd* 173 F.3d 855 (6th. Cir. 1999).

and it could not purge the debtor of tax fraud or affect his criminal liability for failure to file a return under I.R.C. 7203. The court also noted that the debtor did not contest the argument that the Forms were a legal nullity and did not suggest any way that the Forms could have any legal effect.

The position that where a document is a legal nullity it cannot satisfy the definition of a return has been rejected by several courts because this position requires reading a requirement into the Bankruptcy Code that is not explicitly there. In other words, section 523(a)(1)(B) does not state that the return must be filed prior to an assessment by the IRS in order to be effective for dischargeability purposes. For example see *In re Savage*, where the Tenth Circuit BAP stated that this reading would lead to an absurd result.[345] "Effectively, a debtor, for whom the IRS prepares substitute returns, could never discharge taxes. We find nothing in the Bankruptcy Code that would lead us to adopt the IRS's argument."[346]

In a legal memorandum[347], Kathryn A. Zuba, chief, branch 2 (collection, bankruptcy, and summonses), has concluded that an executed Form 870 or Form 4549 is considered a return when accompanied by the schedules prepared by a revenue officer in accordance with section 6020(a) of the I.R.C. for purposes of the Bankruptcy Code. Under section 6020(a) a taxpayer that consents to disclose all information necessary for the preparation of the return by the Service and signs the return will be considered as having filed a return. Under Rev. Rul. 74-203, a Form 870 or 4549 signed by an individual in response to a proposed substitute for return (SFR) is considered a return for that individual for purposes of section 6020(a). It was also noted in the memorandum that the source of the information used to prepare the return is not determinative as to whether a SFR is considered a return.

The exception from discharge under section 532(a)(1)(B) of the Bankruptcy Code does not apply when an individual, by signing a Form 870 waiver, allows the Service to immediately assess the amount calculated on a SFR prepared by an IRS employee and forfeits the right to contest the Service's calculation in Tax Court, according to the memorandum.

Section 6020(b) of the Internal Revenue Code, gives the authority to the IRS to prepare a return from its own knowledge and from other information that can be obtained through testimony or otherwise if the taxpayer fails to file a return or files a false or fraudulent return. The legal memorandum concluded that taxes derived from an SFR covered under section 6020(b) would be treated as excepted from discharge under bankruptcy code section 523(a)(1)(B).

In a bankruptcy case,[348] the IRS issued Notice of Deficiency and, receiving no response, prepared substitute returns for debtor. After seizures of property, debtor "voluntarily" came in and completed tax returns. In a subsequent bankruptcy proceeding, the debtor argued that his taxes were dischargeable under

[345] 218 B.R. 126, 132 (10th Cir. BAP 1998).
[346] 218 B.R. at 132.
[347] ILM 200113026; LTRServ, Apr. 9, 2001, p. 1775.
[348] *In re Walsh*, 87 AFTR2d paragraph 2001-840 (Bankr. D. Minn. Mar. 29, 2001), *aff'd* 2002 US Dist. LEXIS 13616 (D. Minn. 2002).

the "plain meaning" of B.C. section 523(a)(1)(B)(i), since he did in fact file returns. The bankruptcy court disagreed, finding the debtor's "plain meaning" led to an absurd result. Once an involuntary Government-made assessment is final, the court said, the taxpayer's belated filing of a return serves no revenue purpose. Therefore, under section 523(a)(1)(B)(i), the debtor forfeits his right to discharge the taxes in bankruptcy.

A bankruptcy court held that a debtor filed returns when he filed Forms 1040 after the IRS made assessments, and thus his taxes were dischargeable under 11 U.S.C. section 523(a)(1)(B).[349] However, the court ruled that the taxes were nondischargeable under section 523(a)(1)(C) because the debtor had attempted to evade the taxes. The court rejected the Service's first argument that Forms 1040 filed after assessments are made do not constitute returns for purposes of section 523(a)(1)(B). Note the bankruptcy court decision in *Hindenlang v. United States*, which held that forms filed by the debtor after assessment constituted returns, based on the plain language of section 523(a)(1)(B). However, as noted above, the Sixth Circuit reversed both the bankruptcy court and district court's decision in *Hindenlang*. That statute, the *Hindenlang* court concluded, creates a bright-line rule, which says that if the debtor's return was filed less than two years prepetition, the associated taxes are nondischargeable.

Citing *Germantown Trust Co. v. Commissioner*,[350] which established the criteria for a proper return, the bankruptcy court found that the IRS did not dispute that the taxpayer filed the returns, that the returns were executed and sworn to by the taxpayer, that they contained sufficient data to calculate his tax, and that they were not facially irregular or fraudulent. The bankruptcy court determined the position taken by the IRS (that a return could not be considered a return if filed after the tax was assessed) to be meritless, because the IRS's position would result in the court placing a significant additional requirement on the taxpayer to avoid nondischargeability-filing a return prior to assessment. The court noted that Congress chose not to place significance on the time of assessment and that section 523(a)(1)(B)(ii) of the Bankruptcy Code creates a bright-line rule which says that if the debtor's return was filed less than two years prepetition, the associated taxes are nondischargeable.

Other courts have also dealt with the extent to which a return can be considered filed, if filed after the tax is assessed. In *In re Sullivan*,[351] the bankruptcy court held that a debtor's 1981–1984 taxes were dischargeable even though tax returns were filed after the IRS issued a deficiency notice, because the returns were filed before the IRS assessed the taxes and more than two years before the debtor filed for bankruptcy.

However, in *In re Mickens*,[352] the bankruptcy court held that a chapter 7 debtor's 1980–1982 income taxes were not discharged, because the Forms 1040 he filed in 1992, after the IRS had assessed taxes for those years, did not constitute returns. The bankruptcy court held that a chapter 7 debtor's taxes are non-

[349] *In re McGrath*, 217 B.R. 389 (Bankr. N.D.N.Y. 1997).
[350] 309 U.S. 304 (1940).
[351] 200 B.R. 327 (Bankr. N.D. Ohio 1996).
[352] 215 B.R. 693, (Bankr. N.D. Ohio 1997); *aff'd* 173 F.3d 855 (6th Cir. 1999).

dischargeable under 11 U.S.C. section 523(a)(1()(B).[353] The court concluded that substitute returns prepared by the IRS on the debtor's behalf do not constitute "returns" for the purpose of discharging taxes. The court noted that the taxpayer did not file returns for the 1983–1989 and did not swear to the accuracy of the substitute returns the IRS prepared.

In *In re Olson*,[354] the bankruptcy court held that the state tax liabilities, penalties, and interest for the years 1978–1981 were dischargeable because the debts were not excepted from discharge under section 523(a)(1)(B)(i) of the Bankruptcy Code. The court noted, however, that the state tax debts would have been excepted from discharge if the Olsons had been required to file amended returns for these years. Because the State of North Dakota had notified the taxpayer that amended returns were not required for 1978–1981, the tax claims could be discharged.

The district court held that a return must be signed before it is considered filed, reversing a decision by the bankruptcy court holding that an unsigned return was considered a return for tax discharge purposes.[355] The district court noted that both the Tax Court and the federal courts of appeal have consistently held that an unsigned tax return is no return at all, because an unsigned tax return would be insufficient to support a perjury charge based on a false return. Thus, the unsigned return was not deemed filed until the IRS received the signed verification statement, which was within two years before the bankruptcy petition was filed, with the result that the tax was not discharged under the provisions of section 523(a)(1)(B)(ii) of the Bankruptcy Code. The original unsigned return was filed more than two years before the bankruptcy petition was filed.

The taxpayer claimed that the date of assessment for additional taxes was the date when the IRS sent a letter explaining to him the reasons for adjustments to the substitute returns.[356] The bankruptcy court agreed with the government that the taxes were assessed within 240 days of the bankruptcy filing. The bankruptcy court rejected Parker's allegation that the taxes were assessed when the IRS sent a letter to him explaining why adjustments should be made to the taxes shown as due on the substitute returns. The court determined that the date of assessment for bankruptcy purposes is the assessment date as determined under the Internal Revenue Code. Such assessment is made on the date indicated on the certificate of assessments and because this date was within the 240-day period the tax was not discharged.

The bankruptcy court denied the government summary judgment on its argument that the tax was nondischargeable because no return was filed, because the government failed to establish that no returns were filed for the years in question. Citing *In re Gless*,[357] and *In re Berard*,[358] the court ruled that a

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[353] *Id*.

[354] 174 B.R. 543 (Bankr. D. N.D. 1994), *rehearing* 1994 Bankr. LEXIS 1364 (Bankr. D. N.D. 1994).

[355] *In re Lee*, 186 B.R. 539 (S.D. Fla. 1995).

[356] *In re Parker*, 199 B.R. 792 (Bankr. M.D. Fla. 1996).

[357] 179 B.R. 646 (Bankr. D. Neb. 1995).

[358] 181 B.R. 653 (Bankr. M.D. Fla. 1995).

substitute return filed by the IRS can satisfy the requirements of section 523(a)(1)(B)(i) of the Bankruptcy Code provided the debtor cooperates with the IRS in completing the form and furnishes the information to the Service that is necessary to compute the debtor's tax liability. The record did not show whether Parker had contributed to the preparation of the substitute returns, and as a result the court would not rule that the tax was not dischargeable.

A U.S. bankruptcy court held that a bookmaker's taxes for wagering are nondischargeable.[359] The taxpayer argued that his wagering taxes are dischargeable in bankruptcy because he was unaware that a return should be filed. As a result of this lack of knowledge, his debt should be discharged under section 523(a)(1)(C) of the Bankruptcy Code because his failure to file wagering tax returns was excusable, and not willful. The bankruptcy court concluded that although lack of knowledge would be a valid defense in a criminal proceeding, where willfulness is a necessary element of proof, it is irrelevant to the issue of dischargeability under section 523(a)(1)(B)(i) of the Bankruptcy Code. The bankruptcy court explained that because the taxpayer did not file the required tax returns, the taxes at issue were not dischargeable.

(ii) Delinquent Returns

As a general rule, an amended return is not considered a tax return. For example, in *In re Arenson*,[360] the district court agreed with the bankruptcy court that an amended return in response to a substitute return filed by the IRS for the taxpayer is not a return for purposes of section 523(a)(1)(B)(i). The bankruptcy court relied upon the Supreme Court's decision in *Badaracco v. Commissioner*.[361] See § 11.3(b)(iii).

Late tax returns that are filed within 2 years prior to the filing of a bankruptcy petition are nondischargeable according to section 523(a)(1)(B) of the Bankruptcy Code. This requirement is in addition to the three requirements set forth in section 507(a)(8)(A) of the Bankruptcy Code. Taxes due on late tax returns that were filed more than 2 years prior to the filing of the petition and more than 3 years prior to the original due date of the return, but still assessable because of the 3-year statute of limitations assessment, are still not dischargeable. The court in *In re Torrente*[362] supported the concept that sections 523(a)(1)(B)(ii) and 507(a)(8)(A)(iii) of the Bankruptcy Code work together and expand the concept of dischargeability of the tax. However, the bankruptcy court in *In re Doss*,[363] in a very technical interpretation, held that section 507(a)(8)(A)(iii) was inapplicable because the late return was filed more than 2 years before the bankruptcy petition was filed. Thus, a tax that would not otherwise have been dischargeable was considered dischargeable because the taxpayer filed the federal tax return late.

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[359] *In re Spain*, 182 B.R. 233 (Bankr. S.D. Ill. 1995).

[360] 134 B.R. 934 (Bankr. D. Neb. 1990), *aff'd*, 145 B.R. 310 (D. Neb. 1992).

[361] 464 U.S. 386 (1984).

[362] 75 B.R. 193 (Bankr. S.D. Fla. 1987).

[363] 42 B.R. 749 (Bankr. E.D. Ark. 1984).

In *In re Smith*,[364] the court held that a tax related to a late return filed more than 2 years before the bankruptcy petition was filed was not dischargeable under section 507(a)(8)(A)(i) of the Bankruptcy Code, because the due date of the tax return was less than 3 years before the bankruptcy petition was filed.

In many states, the state income or franchise tax is based on the adjusted gross income reported on the federal return. If an adjustment has been made in the federal return, an amended state tax return must be filed in a relatively short time period, such as 20 days. If the state tax return is not filed, it may be considered late and thus the tax may be nondischargeable under section 523(a)(1)(B)(i) of the Bankruptcy Code. The amount that is nondischargeable may be the total amount of the tax for the year, not just the additional state tax resulting from a federal tax adjustment.

When a taxpayer's federal tax liability is changed due to an audit, states that have an income tax require the taxpayer to report a change in federal income tax to the state. The method of making the report and the time of the report will vary among the states requiring the report. A majority of the states with an income tax require the taxpayer to file an amended return with the state and attach a copy of the revenue agent's report. Other states allow the debtor to file an amended return, provide the state with a copy of the revenue agent's report, or file a form to report the change resulting from the audit.

In states that require an amended return, courts have generally held that the amended return is not a return for purposes of section 523(a)(1)(B). However, a few courts have held that the amended return was a return and thus a tax that otherwise would have been discharged is no longer discharged if the bankruptcy petition was filed within two years after the amended return was filed.[365]

For those states that require a report—such as a special form or a copy of revenue agent's report—the courts have generally held that the filing of these reports do not constitute a return.[366] However, in *In re Blutter*,[367] the bankruptcy court held that a report was a required return.

In determining whether the petition was filed after the 2-year period lapsed, careful consideration must be given to the exact date that action was taken. For a late return, the date of filing is based upon the "physical delivery rule," which holds that documents are deemed "filed" when "delivered and received" by the IRS.[368]

In *In re Smith*,[369] the debtor argued that because section 523 is a bankruptcy statute, questions of bankruptcy law are involved and the Internal Revenue Code is inapplicable. As support for this proposition, Debtor-Appellant relies on *In re American Healthcare Management, Inc.*,[370] and *In re Buyer's Club*

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[364] 109 B.R. 243 (Bankr. W.D. Ky. 1989); *aff'd*, 114 B.R. 473 (Bankr. W.D. Ky. 1989).

[365] *In re Jones*, 158 B.R. 535 (Bankr. N.D. Ga. 1993); *In re Greenstein*, 95 B.R. 583 (Bankr. N.D. Ill. 1989); *In re Cohn*, 96 B.R. 827 (Bankr. N.D. Ill. 1988); *In re Haywood*, 62 B.R. 482 (Bankr. N.D. Ill. 1986).

[366] *See In re Jackson*, 184 F.3d 1046 (9th Cir. 1999).

[367] 177 B.R. 209 (Bankr. S.D.N.Y. 1995).

[368] *Miller v. United States*, 784 F.2d 728, 730 (6th Cir. 1986).

[369] 186 B.R. 411 (N.D. Ohio 1995).

[370] 900 F.2d 827 (5th Cir. 1990).

Markets, Inc.[371] Upon examination, the district court found that neither is controlling of, or even germane to, the instant case.

There is a statutory exception to the physical delivery rule under I.R.C. section 7502, referred to as the "timely mailing is timely filing" exception. I.R.C. section 7502 provides that if a return is mailed on or before its prescribed due date, the date of delivery will be deemed to be the last date of the postmark on the cover in which such return is mailed. However, in cases where the tax return is late this exception is inapplicable.[372]

In *In re Smith,* the debtor filed his bankruptcy petition on Saturday, November 23, 1993. On Thursday, November 21, 1991, the debtor executed his tax returns for 1987–1989, and forwarded them to the IRS on Friday, November 22, 1991, via Federal Express. The returns were stamped received by the IRS on November 25, 1991. The court concluded that as the returns were not filed until November 25, 1991, they were filed within the two-year window before the date of the filing of the petition. The taxes for those years were therefore not dischargeable.

Another factor to consider is the date that the petition is filed. If a petition is filed on a Saturday or Sunday, Monday should be considered as the date the petition is filed. Fed. R. Bankr. P. 9006 states, in relevant part:

> (A)Computation. In computing any period of time prescribed or allowed by . . . any applicable statute, the day of the . . . event, . . . from which the designated period of time begins to run shall not be included. The last day of the period so computed shall be included, unless it is a Saturday, a Sunday, . . . in which event the period runs until the end of the next day which is not on the aforementioned days.

In *In re Smith,* bankruptcy court held that "the date which falls 'two years before the date of the filing of the petition' under section 523(a)(1)(B)(ii) does not represent a filing deadline which can be expanded by Fed. R. Bankr. P. 9006(A)." The Sixth Circuit in *In re Butcher*[373] rejected a similar claim, and held that under a Bankruptcy Code provision requiring action to avoid preferential or fraudulent treatment to be commenced within two years after appointment of the trustee, the two-year period begins to run as of the date of the trustee's appointment, rather than the day after the trustee's appointment, and expires 24 months later, irrespective of whether the last day falls on a Saturday, Sunday, or legal holiday.

The date that the return is filed is strictly enforced. For example, for untimely filed income tax returns, the filing date is the date received by the Service.[374] The district court held that a couple was not entitled to a refund because the return was received by the IRS two days late. The district court noted that for untimely filed income tax returns, the tax return is considered received on the actual date received by the IRS and not the date mailed.

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[371] 100 B.R. 37 (Bankr. D. Col. 1989).

[372] *Sanderling, Inc. v. Commissioner*, 67 T.C. 176 (1976), *aff'd in part*, 571 F.2d 174 (3d Cir. 1978).

[373] 829 F.2d 596 (6th Cir. 1987), *cert. denied*, 484 U.S. 1078 (1988).

[374] Lo*ckery v. United States*, 1998 U.S. Dist. LEXIS 17657, 98-2 U.S.T.C. (CCH) ¶ 50,808 (E.D. Mich. 1999).

While acknowledging that this decision was unfortunate, the district court noted that the Sixth Circuit is consistent in denying equitable pleas to disregard the strict timing rules of the I.R.C. and the Bankruptcy Code.[375]

(iii) Fraudulent Returns or Attempts to Evade or Defeat the Tax

These taxes are never dischargeable under section 523(a)(1)(B) of the Bankruptcy Code. The Supreme Court held, in *Grogan v. Garner*,[376] that the proof for the dischargeability exception (section 523) is the ordinary "preponderance of the evidence" standard. Phelan and Bezozo note that this is

> contrary to the standard of proof applied by the bankruptcy court when determining the amount of legality of any tax, or penalty relating to a tax, under section 505(a). Because of the different standards that may be applied to the IRS's assertion of fraud in connection with a tax claim, it is possible that the bankruptcy court could find that the taxes are not fraudulent for purposes of asserting a civil tax penalty, but that the taxes are fraudulent for purposes of determining their dischargeability.[377]

A question arises as to the extent that the nondischargeability of the tax would apply in the case where the first return was fraudulent but the taxpayer subsequently filed a nonfraudulent tax return. In *Badaracco v. Commissioner*,[378] the Supreme Court held that the second filing did not remove the statute of limitations that applies to fraudulent returns. It would appear that the same rule would apply to dischargeability of taxes under section 523 of the Bankruptcy Code and the taxpayer would not be discharged from the tax.

In *Ronald Eugene Nye v. United States*,[379] the district court determined that tax liabilities associated with a fraudulent return due more than 3 years before the bankruptcy petition was filed were not dischargeable. The court also held that the issue of fraud was barred by the doctrine of *res judicata.* The IRS had determined deficiencies and fraud penalties against the taxpayer for tax years 1980 and 1981. The determination was challenged in the Tax Court and that case ended in a stipulated decision under which Nye agreed to pay the additional taxes, interest, and a 5 percent fraud penalty. Later, a chapter 13 petition was filed.

The court held that the fraud penalties were dischargeable under section 523(a)(7)(B) of the Bankruptcy Code because the penalties arose from a transaction occurring prior to 3 years before the filing of the bankruptcy petition.

In *Creigh A. Bogart v. United States*,[380] the bankruptcy court ruled that the failure to file estimated returns and to pay tax liability out of proceeds from the sale of a partnership interest was not fraud. The court held that the IRS failed to show by a preponderance of the evidence that Bogart willfully intended to

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[375] *Smith v. United States*, 96 F.3d 800 (6th Cir. 1996).
[376] 498 U.S. 797 (1991).
[377] Phelan and Bezozo, *Bankruptcy Taxation* (1991) at 153.
[378] 104 S. Ct. 756 (1984).
[379] No. 91-4009 (N.D. Ohio April 15, 1992).
[380] Adv. No. 92-24 (Bankr. M.D. Fla. 1992).

evade the tax. The court noted that "[s]imply failing to pay a tax liability is not tantamount to fraud or an attempt to defeat or evade the tax."

As a general rule, courts have held that taxes assessed against those that attempt to evade taxes, including tax protesters, are not dischargeable. The Fifth Circuit held that tax assessments against a couple were not dischargeable in bankruptcy because the couple had willfully evaded their tax liabilities.[381] The Fifth Circuit concurred with the lower courts' conclusions that the taxpayers' conduct indicated fraud, and rejected all of the arguments made by the taxpayers as meritless.

In the case of *Macks v. Clinton,*[382] the district court concluded that Kenneth Macks's tax liability was previously determined in a Tax Court proceeding. The IRS sought to collect from Harvey Macks the unpaid tax liabilities of his brother, Kenneth Macks, based on an alleged fraudulent conveyance of Kenneth Macks's real property to Harvey Macks.

Kenneth Macks asserted that the tax liabilities were discharged in his bankruptcy case, but the district court granted the government's motion to amend the summary judgment to provide that Kenneth Macks owed the taxes. The district court noted that a bankruptcy discharge does not affect unpaid tax liabilities where there has been a fraudulent conveyance.

The district court ordered that judgment be entered declaring that Kenneth Macks was the owner of the real property and that Harvey Macks had no interest therein. The court then held that the IRS had valid tax liens encumbering the real property but subject to a previously recorded bank's lien on one of the two parcels of real property.

The district court concluded that the government had proved that fraudulent conveyance had occurred because Kenneth Macks had intended to defraud the government. No consideration was ever paid for the purported property transfers.

In *In re Angel,*[383] the bankruptcy court held that Steven M. Angel's tax liabilities were excepted from discharge under section 523(a)(1)(C) of the Bankruptcy Code because Angel's action went beyond a mere failure to pay. Although he owed over $200,000 in tax debts, Angel purchased several luxury motor vehicles, paid $225,000 for the construction of a home, and then filed for bankruptcy. The court noted that because Angel had a present ability to pay his taxes and instead bought items for his own enjoyment, the court would not be party to such tax-evasive actions.

In *In re Smith,*[384] the bankruptcy court concluded that the filing of false W-4s overstating exemptions is insufficient, standing alone, to constitute a willful attempt to evade or defeat a tax liability. David Wayne Smith filed for a bankruptcy petition on April 19, 1993, and claimed that his outstanding personal income taxes were dischargeable because they were due more than 3 years prior to the bankruptcy filing. The government argued that Smith's taxes were non-

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[381] *United States v. Dan E. Warden*, 1995 U.S. App. LEXIS 17117, No. 94-20438 (5th Cir. 1995).
[382] 843 F. Supp. 1440 (M.D. Fla. 1993).
[383] 94-1 USTC (CCH) ¶ 50,239 (Bankr. W.D. Okla. 1994).
[384] 169 B.R. 55 (Bankr. S.D. Ind. 1994).

dischargeable under section 523(a)(1)(C) of the Bankruptcy Code because he filed fraudulent returns or willfully attempted to evade tax by submitting false W-4s that resulted in underwithholdings.

In reaching the conclusion that the filing of the false W-4s was not considered fraudulent, the court noted that Smith submitted reasonably accurate and timely tax returns for each of the taxable years at issue and professed a good-faith intention to pay his tax liability. According to the district court, the bankruptcy court applied the wrong legal standard— "Willful connotes an act done with a bad purpose or with an evil motive." District court's position was that "willful" in this context requires only a voluntary, conscious and intentional violation of a known legal duty. The Bankruptcy Court therefore erroneously granted the debtor a discharge.[385]

In *Toti v. United States*,[386] the Sixth Circuit determined that an attempt to evade a tax can result in the tax's not being discharged under section 523(a)(1)(C) of the Bankruptcy Code. The Sixth Circuit held that the government needs to prove specific criminal intent in order to invoke the evasion exception to discharge.

As noted above, section 523(a)(1)(C) of the Bankruptcy Code provides that when the taxpayer has willfully attempted to evade his taxes, they may not be discharged. The decision in *Toti* suggests that, in most cases, it will be extremely difficult for taxpayers to claim there was no willful attempt on their part to evade taxes.

Robert G. Nath noted, in describing the interesting aspect of this case, that the "remarkable affirmance is of the factual finding of evasion."[387] The court noted that Toti had failed to file his obligations. Because the failure was with knowledge of the duty to file and was voluntary, conscious, and intentional, the court held that Toti had evaded his taxes and as a result could not get a discharge.

In *In re Bruner*,[388] the Fifth Circuit, affirming both the district court and bankruptcy court decisions, held that a couple's tax liabilities were not dischargeable in bankruptcy, because they had willfully attempted to evade or defeat their tax obligations. The Bruners filed a joint income tax return for 1980, but failed to file returns for the next eight years. In 1988, the husband, a surgeon, pleaded guilty to willfully failing to file his 1981 tax return. The district court ordered him to pay a $10,000 fine, pay his tax liabilities for 1981, and file returns for 1981–1988. The IRS created substitute returns for some of those years, and the Bruners filed the other returns. Based on these returns, the IRS determined a $290,000 deficiency against the couple for 1981–1988. The Bruners made payments on the debt between 1989 and 1993. In 1993, the Bruners filed chapter 7 bankruptcy petition and asked the bankruptcy court to determine the tax. The IRS filed a proof of claim for over $365,000. The bankruptcy court held that the Bruners' tax liabilities for 1981, 1983, 1986, 1987, and 1988 were not dischargeable, pursuant section 523(a)(1)(C) of the Bankruptcy Code, because the Bruners

[385] *In re Smith*, 202 B.R. 277 (S.D. Ind. 1996).
[386] 24 F.3d 806 (6th Cir. 1994).
[387] 64 Tax Notes 102 (July 4, 1994).
[388] 55 F.3d 195 (5th Cir. 1995).

had willfully attempted to evade or defeat their taxes for those years. The district court affirmed.

The Fifth Circuit affirmed the decision of both the bankruptcy court and district, noting that the Bruners had voluntarily and intentionally violated their duty to pay taxes. The court noted that the couple had filed a 1980 tax return, indicating that they knew of their duty. Also, large cash transactions made by the Bruners and their concession that Three-L Ministries was a shell entity for hiding income and assets were indication of their intent to evade taxes.

The Fifth Circuit noted that in *In re Toti,* the Sixth Circuit held that section 523(a)(1)(C) "includes acts of commission and acts of omission." The Fifth Circuit noted that the Bruners had committed both. The Fifth Circuit noted that this approach was preferable to the position taken by the Eleventh Circuit in *In re Haas,*[389] which held that a man who had filed his tax returns but had not remitted payment was entitled to have his tax debts discharged in bankruptcy, because he was an honest debtor. The Haas court noted that the tax code imposes a heavier criminal liability on those who willfully attempt to evade their taxes than it does on those who simply fail to pay, and reasoned that section 523(a)(1)(C) of the Bankruptcy Code should follow the usage of the Internal Revenue Code. The Eleventh Circuit concluded that the debtor's allocation of assets to liabilities other than taxes, even though the debtor is aware of the taxes due and owing, does not constitute willful evasion.

Disagreeing with the Eleventh Circuit's position, the Fifth Circuit was not convinced that the language of the Internal Revenue Code must be interpreted the same as that of the Bankruptcy Code. The court concluded by pointing out that the Bruners was not a case of mere nonpayment, but involved much more flagrant conduct aimed at avoiding even the imposition of a tax assessment against them. A district court affirmed a bankruptcy court's decision that held that a couple was entitled to a discharge of the tax liabilities they had failed to pay with respect to disallowed tax shelter losses. Relying on *In re Haas,* the district court agreed with the bankruptcy court that the evidence established only that the taxpayers failed to pay their taxes.[390]

Section 523(a)(1)(C) of the Bankruptcy Code provides that any tax with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax is not dischargeable. Based on this section of the Code, the Tenth Circuit has held nondischargeable a tax debt for which the debtor's only attempt to evade or defeat tax was his concealment of assets out of which the tax debt might be satisfied.[391] The court relied on opinions from the Fifth and Sixth Circuits and from bankruptcy courts in other jurisdictions to construe the phrase "in any manner" in section 523(a)(1)(C) as "sufficiently broad to include willful attempts to evade taxes by concealing assets to protect them from execution or attachment." [392]

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[389] 48 F.3d 1153 (11th Cir. 1995).

[390] *In re Williams*, 186 B.R. 521 (M.D. Fla. 1995).

[391] *Dalton v. IRS*, 77 F.3d 1297 (10th Cir. 1996).

[392] *In re Bruner*, 55 F.3d 195, 200 (5th Cir. 1995); *In re Toti*, 24 F.3d 806, 808-09 (6th Cir.), *cert. denied,* 115 S. Ct. 482 (1994).

The Tenth Circuit noted that while nonpayment, by itself, does not compel a finding that the given tax debt is nondischargeable, it is relevant evidence that a court should consider in the totality of conduct to determine whether or not the debtor willfully attempted to evade or defeat taxes. Both the bankruptcy court and the district court concluded that Dalton's tax debts were nondischargeable.

The Eleventh Circuit, reluctantly reversing the bankruptcy and district courts, has held that a debtor's efforts to evade payment, not assessment, was not a willful attempt to evade or defeat such tax under section 523(a)(1)(C) of the Bankruptcy Code.[393] The Eleventh Circuit subsequently voted for a rehearing en banc and vacated the panel's decision.[394] In a subsequent rehearing the taxes were held not to be discharged.[395]

An IRS audit revealed that Leroy Charles Griffith substantially underpaid his taxes for the years 1969-1970, 1972-1976, and 1978. Less than a month after the Tax Court issued its decision, on October 10, 1988, NuWave, Inc. was incorporated, with Griffith's long-time live-in girlfriend, Linda, as sole shareholder. On June 8, 1989, Linda and Griffith married, and Griffith signed an antenuptial agreement in which he transferred stock in two of the corporations, $390,000 in promissory notes, and other assets to NuWave, Inc. The transfers occurred the same day Griffith got married. The IRS made an assessment against Griffith on September 28, 1989. However, the assets transferred pursuant to the antenuptial agreement were insulated from being levied upon because assets held by tenants in the entirety cannot be levied upon without a judgment against both owners. Griffith no longer had any ownership interest in those assets transferred to NuWave, Inc.

The bankruptcy court determined that Griffith attempted to evade the payment of $2 million in tax debt, and as a result the taxes were nondischargeable under section 523(a)(1)(C) of the Bankruptcy Code. After the bankruptcy court's decision, the Eleventh Circuit decided in *In re Haas*, that the taxes were dischargeable. Haas filed accurate tax returns but had not paid the taxes due; instead, he used his income to pay business and personal debts. The Eleventh Circuit concluded that Haas's conduct did not amount to an attempt to willfully evade or defeat taxes at the assessment stage, which would have precluded a discharge. In *Griffith*'s case, the district court affirmed the lower court's denial of a discharge because Griffith had engaged in a fraudulent transfer of assets to prevent the collection of his taxes. The district court distinguished Haas, stating that, unlike Haas, Griffith had engaged in dubious transfers of assets.

In *Hass*, upon filing for bankruptcy, the taxpayer sought discharge of the tax debts, which the government opposed on the basis of section 523(a)(1)(C). The *Haas* panel found that a literal reading of the statute, including the broad phrase "in any manner," would conflict with the goals of bankruptcy—to provide an opportunity for a fresh start. The panel noted that the language ("willfully attempting in any manner to evade or defeat any tax") in section 523(a)(1)(C) of the Bankruptcy Code is identical to the wording ("willfully attempting in any

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[393] *In re Griffith*, 174 F.3d 1222 (11th Cir. 1999).

[394] *In re Griffith*, 84 A.F.T.R.2d ¶ 99-5188 (11th Cir. 1999).

[395] *In re Griffith*, 206 F.3d 1389 (11th Cir. 2000).

manner to evade or defeat any tax or the payment thereof") in section 6531(2) except that "or the payment thereof" is not in the Bankruptcy Code. The panel relied on the absence of the phrase "or the payment thereof" from section 523(a)(1)(C) to conclude that the provision precludes discharge when the debtor willfully attempted to evade or defeat the tax at the assessment stage, but does not preclude discharge when there has been such evasion at the payment stage. The Eleventh Circuit noted that while acknowledging that the result in *Haas* was correct, the Tenth Circuit in *Dalton v. IRS* expressly rejected the proposition (adopted in *Haas*) that section 523(a)(1)(C) applies only to conduct constituting evasion of the assessment of a tax and does not apply to conduct constituting evasion of the payment or collection thereof. Like *In re Griffith, Dalton* involved only conduct evidencing attempts to evade the payment or collection of taxes. The *Griffith* court noted that while relying upon the broad language of section 523(a)(1)(C)—"willfully attempted in any manner to evade or defeat such tax"—and in particular upon the broad phrase "in any manner," the *Dalton* court held that section 523(a)(1)(C) makes a tax nondischargeable when the debtor attempted to evade a payment or collection of the tax, even though there was no evasion with respect to the assessment.[396] The *Dalton* court also relied upon the purpose of Congress to relieve only "honest" debtors from their tax debts.

The Eleventh Circuit was bound by *Haas,* but indicated that the decision was a candidate for the entire Eleventh Circuit or the Supreme Court to reconsider. The Eleventh Circuit concluded, "[b]ecause we are troubled by the application of the *Haas* holding to the facts of the instant case, because we doubt that this consequence was argued to the *Haas* panel, and because of the conflict in the circuits arising from the inconsistency between *Haas* and *Dalton* (and the decisions cited therein), we think that the instant case is a candidate for en banc reconsideration." Griffith was subsequently vacated and affirmed.

The bankruptcy court held that a chapter 7 debtor's $1 million tax liability is dischargeable, finding that his failure to file returns and pay taxes was the result of his alcoholism, not a scheme to evade taxes.[397] The taxpayer was a severe alcoholic for 10 years. During that period he ignored his financial responsibilities and failed to file tax returns. In 1994, after attending Alcoholics Anonymous and becoming sober, the taxpayer pleaded guilty to criminal tax charges. The taxpayer worked with the IRS to file returns and did not destroy records, hide assets, conceal property, or accumulate wealth. After filing for bankruptcy, the taxpayer commenced an adversary proceeding to determine if his 1982–1992 taxes, interest, and penalties of more than $1 million were dischargeable.

The bankruptcy court held that the taxpayer's failure to file returns and pay taxes when he had the resources to pay was not, by itself, willful or dishonest. Citing *In re Haas,*[398] in which the Eleventh Circuit held that not "every knowing failure to pay taxes constitute[s] an evasion of taxes under section 523(a)(1)(C)," the bankruptcy court found the failures to file and pay not part of a tax evasion scheme, but rather it "was simply irresponsible as a result of his alcoholism."

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[396] *In re Dalton*, 77 F.3d 1297 (10th Cir. 1996).

[397] *In re Fretz*, 239 B.R. 605 (Bankr. N.D. Ala. 1999); *aff'd* 248 B.R. 183 (N.D. Ala. 2000).

[398] 48 F.3d 1153 (11th Cir. 1995).

However, in the case of *Fretz*, the Eleventh Circuit[399] reversed the bankruptcy court's decision by holding that a bankrupt individual's failure to file tax returns and to pay taxes is sufficient, even without any supporting affirmative conduct, to show that he willfully attempted to evade or defeat a tax within the meaning of 11 U.S.C. section 523(a)(1)(C)'s nondischarge provision.

The Seventh Circuit has affirmed the denial of a discharge for a couple's tax debts, based on a bankruptcy court's findings that the couple willfully attempted to evade tax payment. As part of a chapter 7 case, the couple sought to discharge tax obligations of approximately $2 million for the years 1975, 1977–1981, and 1987–1988.[400]

On appeal to the Seventh Circuit, the couple acknowledged that they had transferred cash, stock, and land to their children, created corporations owned by the children but controlled by the husband, paid off undue loans from other creditors while failing to pay their taxes, and lowered the husband's salary to avoid an IRS levy. However, the couple challenged the bankruptcy court's findings that their conduct was designed to avoid paying taxes and that they acted willfully.

The Seventh Circuit rejected the couple's assertion that the bankruptcy court had drawn impermissible inferences from the record. The Court noted that because only family members testified without contradiction that the couple's motives were honest, their testimony was not controlling and that the bankruptcy court simply found the testimony incredible, and the family's actions speak for themselves. Willfulness, according to the Seventh Circuit, *mens rea* can be inferred from conduct, and the sum total of the couple's conduct provided ample basis for finding voluntary, conscious, and intentional attempts to avoid paying taxes.

The district court held that a prior decision by this court decided only that the taxpayers' trust held assets as a nominee, not that the taxpayers had attempted to evade the payment of taxes.[401]

The government moved for summary judgment in an attempt to enforce its tax liens because the taxpayers' 1976–1977 and 1985 tax debts that were subject to prepetition tax liens were not discharged. The government argued that under section 523(a)(1)(C) of the Bankruptcy Code, the taxes would not be discharged because the taxpayers had willfully attempted to evade those taxes. The district court held that the prior decision merely identified the owner of the property in question.

(iv) Penalties

In general, penalties that are a priority item under section 507(a)(8) of the Bankruptcy Code are not dischargeable. Those that are not priority items may be discharged in addition to being subordinated in many cases, as discussed above.

One unresolved issue is the extent to which a tax penalty owed on taxes that were due more than 3 years before the petition was filed can be discharged if the

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[399] *In re Fretz*, 244 F.3d 1323 (11th Cir. 2001).
[400] *In re Zuhone* Jr., 88 F.3d 469 (7th Cir. 1996).
[401] *United States v. Comer*, 222 B.R. 555 (E.D. Mich. 1998).

underlying tax is nondischargeable. The Tenth and Eleventh Circuits have held that the penalty is discharged and that section 507(a)(8) of the Bankruptcy Code should be read literally, to allow for the discharge of the tax.[402] The Seventh Circuit held differently in *Cassidy v. Commissioner.*[403]

The Ninth Circuit also held, in *McKay v. United States,*[404] that the penalty may be discharged even though the tax is not discharged. The tax may not be subject to discharge if it was subject to the two-year requirement under section 523(a)(1)(B)(iii), because the return was filed later or the tax was assessed within 240 days under section 507(a)(8)(A)(ii).

The problem arises because of the conflict of the provisions in subparagraphs A and B of section 523(a)(7) of the Bankruptcy Code. Subparagraph A is generally viewed as a codification of the pre-Code position of the government that all noncompensatory penalties are discharged only if the related tax is discharged. However, subparagraph B was added to provide for a discharge of these penalties if they "were imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition." The transaction or event is generally held to be the due date or the filing date of the return. Thus, a situation is created in which the tax may not be discharged but the penalty is discharged.

In *Burns,* the Eleventh Circuit held that any tax penalty imposed with respect to a transaction or event that occurred prior to 3 years before the date of the filing of a bankruptcy petition would be dischargeable under section 523(a)(7) of the Bankruptcy Code.[405] The IRS in developing a collateral agreement with the taxpayer as reported in *In re William Thomas Plachter, Jr.,*[406] concluded that fraud penalties on taxes that were not dischargeable but were due more than 3 years before the petition was filed, were dischargeable as a result of the debtors' bankruptcy, in accordance with *Burns.*

In *Ronald Eugene Nye v. United States,*[407] the district court determined that fraud penalties, incurred on transactions ending more than 3 years before the filing of the petition, were dischargeable even though the tax to which the penalties related was not dischargeable.

(v) Failure to File Proof of Claim

If the IRS has knowledge of a case and does not file a proof of claim (in the case of a chapter 11 case, the debt is not listed on the schedules), it would appear that once the bar date passes for filing a proof of claim, the IRS has no recourse to collect the tax. In *In re Marshall Andrew Ryan,*[408] the IRS attempted to collect on a prepetition tax claim relating to an earlier chapter 13 case in which the IRS failed to timely file a proof of claim. The bankruptcy court, in a subsequent chapter 13

[402] *Roberts v. United States*, 90-2 USTC (CCH) ¶ 50,484 (10th Cir. 1990); *In re Burns*, 887 F.2d 1541 (11th Cir. 1989).
[403] 814 F.2d 477 (7th Cir. 1987). *See In re Hartman*, 110 B.R. 951 (Bankr. D.C. Kan. 1990).
[404] 957 F.2d 689 (9th Cir. 1992).
[405] 887 F.2d 1541 (11th Cir. 1989).
[406] 1992 U.S. Dist. LEXIS 17234 (S.D. Fla. 1992).
[407] No. 91-4009 (N.D. Ohio Mar. 19, 1992).
[408] 78 B.R. 175 (Bankr. E.D. Tenn. 1987).

case by the same debtor, ruled that the prepetition taxes were discharged without payment because the IRS failed to timely file the proof of claim. The IRS also held that postpetition tax claims relating to the earlier case are not discharged because section 1305(a)(1) of the Bankruptcy Code allows the debtor to collect from the plan or directly from the debtor.

In *In re Fein*,[409] the Fifth Circuit held that a priority tax was not discharged even though a proof of claim was not filed and the debt was not listed in the schedules filed. Bruce Fein filed a chapter 11 petition in April 1991, during a period when the IRS was auditing his returns for 1983–1986 and 1989. Although Fein did not list the IRS as a creditor, he did notify the IRS of his bankruptcy petition. A proof of claim was not filed by the IRS, and Fein's plan of reorganization was confirmed in December 1991.

In 1992, the IRS issued a notice of deficiency for the years 1983–1985 and 1989, indicating that certain losses with respect to Fein's participation in a tax shelter were not deductible. Fein objected on the basis that the tax liabilities had been discharged. Both the bankruptcy court and the district court held that the taxes were not discharged.

Citing *In re Grynberg*[410] and *In re Gurwitch*,[411] the Fifth Circuit stated "in the case of individual debtors, Congress consciously opted to place a higher priority on revenue collection than on debtor rehabilitation or ensuring a fresh start."

The issuance of a deficiency notice, according to the district court in *In re Eddie Burrell*,[412] does not qualify for the filing of a proof of claim. Eddie Burrell filed a chapter 13 petition on November 18, 1985. The IRS, on December 15, 1985, sent Burrell a deficiency notice, indicating that he owed approximately $100,000 in taxes, interest, and penalties. The IRS did not file a formal proof of claim until after the deadline for filing proofs of claim.

The district court has affirmed the bankruptcy court's holding that the IRS's deficiency notice did not reflect "an intent to hold the debtor liable and make demand for payment," which are crucial factors in detecting the filing of an informal claim. The court noted that a deficiency notice merely notifies the taxpayer of the amount of the tax deficiency and of its right to a redetermination of the amount of the tax.

Even if a proof of claim is filed and the IRS forgets to make a phone call, the claim may be disallowed. In *In re William P. Whitney*,[413] William Whitney, who had previously filed a bankruptcy petition, filed a motion for the court to determine the tax liability based on an IRS proof of claim. The date for a pretrial conference was continued six times. At the request of the IRS, the matter was continued a final time. The pretrial conference was to be via a conference call that the IRS was to initiate, but it failed to make the call. The court disallowed the government's proof of claim and ordered that it be stricken from the files, noting that the IRS failed to give an adequate reason for not making the conference call.

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[409] 22 F.3d 689 (9th Cir. 1992).
[410] 986 F.2d 367 (10th Cir. 1993).
[411] 794 F.2d 584 (11th Cir. 1986).
[412] 1988 U.S. Dist.; LEXIS 16297 (N.D. Ill. 1989).
[413] No. 1-85-02309; LEXIS 89 TNT 30-20 (Bankr. S.D. Ohio 1989).

In the case of a secured lien, the Ninth Circuit BAP held that there is no requirement that the IRS file a proof of claim to protect a secured tax lien.[414]

For additional discussion of the proof of claims and the importance of filing, see § 10.3(b).

(vi) Impact of Discharge

To obtain proper discharge of a tax, the determination of dischargeability must be made by the court. For the judge to rule on the dischargeability of a tax claim, a dischargeability complaint is filed by the debtor or taxing authority. It would appear that, if neither the debtor nor the taxing authority brings a dischargeability action in the bankruptcy court, the dischargeability of the tax will be decided by nonbankruptcy courts.

Taxes that are commonly discharged include:

- Income tax where filed timely with a due date more than 3 years prior to the petition date;
- Non-trust-fund portion of payroll tax returns and all unemployment taxes (with a due date 3 years prior to the petition date);
- Audit deficiencies assessed over 240 days before the petition, where original returns were filed timely and tax is due more than 3 years prior to the petition date.[415]

The court held, in *In re Andrew Ferrara*,[416] that, under section 523(a)(7)(B) of the Bankruptcy Code, tax penalties imposed within 3 years of the filing of a bankruptcy petition are not dischargeable under chapter 7.

Ferrara, a partner in JSA Builders, filed a chapter 7 bankruptcy petition in April 1984. Under Ohio law, Ferrara was liable for the debts of JSA. In July 1984, he was discharged of all debts except taxes, fines, and penalties as provided in section 523 of the Bankruptcy Code. Ferrara had not filed partnership returns for JSA. The IRS assessed penalties against JSA for failure to file timely partnership tax returns. Ferrara argued that he was not liable for the penalties and asked the court to discharge his tax debts. The government claimed that the tax penalties were not dischargeable, because they were incurred within 3 years of the filing of Ferrara's bankruptcy petition. See § 11.3(b)(iv).

Taxes that are incurred and not paid by a trustee of an estate of an individual that filed a chapter 7 or chapter 11 petition because of a lack of free assets are not dischargeable and, it appears, are also not transferable back to the individual (see § 4.3(h)). A personal tax that has been discharged only frees the individual from the discharge and does not free any other party that is also responsible for the same debt.[417] Thus, if only one spouse files a bankruptcy petition and is discharged of all debts, the IRS could collect from the other spouse if they previ-

[414] *In re Bisch*, 159 B.R. 546 (Bankr. 9th Cir. 1993).
[415] Rosen, Taxes Discharged in Bankruptcy (mimeograph, 1983) at 2.
[416] 103 B.R. 870 (Bankr. N.D. Ohio 1989).
[417] *Kathy B. Enterprises, Inc.*, 84-2 USTC (CCH) ¶ 9620 (D.C. Ariz. 1984); *aff'd*, 779 F.2d 143 (9th Cir. 1986).

ously filed joint tax returns. A tax lien on property that is exempt from the bankruptcy estate follows the property and is not discharged by the bankruptcy proceeding.

After the tax has been discharged, the taxpayer should request the IRS to abate the tax and release tax liens, if any. This request is made in a letter specifying the type of tax, period of tax, and taxpayer's ID number. Included with the letter should be a copy of the discharge and a copy of schedules A-1 and B-4 of the bankruptcy petition. The letter should be sent to the Special Procedures Function in the appropriate district.

Depending on the financial condition of the debtor, the prospects for future income, and other factors, the tax authority may agree to a compromise. Under these conditions, the amount of tax due is generally greater than the ability of the debtor to pay. As part of the compromise, or separately, the IRS may also agree to develop a plan where tax payments are made in installments. Form 433-D, Installment Agreement, is used to formalize the payment plan. A copy of the form is presented in Exhibit 11.2. This form may be used for agreements reached with the IRS in out-of-court settlements or for the payment of taxes under a plan where, because of events subsequent to confirmation of the plan, the taxpayer is unable to make full payments. An installment payment plan may be entered into while a bankruptcy case is pending, but it will not go into effect until the bankruptcy is dismissed. A compromise and/or an installment agreement may deal with both withholding taxes and other taxes due, such as the employer's share of social security taxes and withheld income taxes.

(vii) Chapter 13

Taxes with priority are not exempt from a discharge under chapter 13, but section 1322 of the Bankruptcy Code provides that a plan must allow for the payment of all claims with priority under Bankruptcy Code section 507. The net effect of this provision is that the government will still receive payment in full for taxes due if a claim is filed. It would, however, appear that priority taxes including interest and penalties due because of a late return, a fraudulent return, or a failure to file a return would be dischargeable. A bankruptcy judge, in *In re Alyce M. Sampson,*[418] held that a plan in a chapter 13 case that provided nothing for unsecured creditors, including the IRS, resulted in all debts included in the plan being discharged, including the tax claims. In *In re Irving C. Newcomb, Jr.,*[419] the court held that first-quarter tax liability for withholding and FICA taxes was dischargeable because a proof of claim was not filed. The IRS had filed a proof of claim for the second and third quarters, and the judge did allow the IRS to file an amended proof of claim, ruling that a new claim was not asserted but that the proof of claim was filed to correct a defect in the claim originally filed.

Once a chapter 13 plan has been completed, the IRS should not attempt to collect prepetition taxes, according to the bankruptcy court in *In re Mary Germaine.*[420]

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[418] No. 81-02188; LEXIS TNT 31-63 (Bankr. D. Idaho 1985).

[419] 60 B.R. 520 (Bankr. W.D. Va. 1986).

[420] No. 86-01880 (Bankr. W.D. Wash. Nov. 4, 1991), *aff'd*, 152 B.R. 619 (BAAP 9th Cir. 1993).

EXHIBIT 11.2

IRS Form 433-D, Installment Agreement

Form **9465** (Rev. December 2003) Department of the Treasury Internal Revenue Service

Installment Agreement Request

▶ **If you are filing this form with your tax return, attach it to the front of the return. Otherwise, see instructions.**

OMB No. 1545-1350

Caution: *Do not file this form if you are currently making payments on an installment agreement. Instead, call 1-800-829-1040. If you are in bankruptcy or we have accepted your offer-in-compromise, see* ***Bankruptcy or Offer-in-Compromise*** *below.*

1 Your first name and initial | Last name | **Your social security number**

If a joint return, spouse's first name and initial | Last name | **Spouse's social security number**

Your current address (number and street). If you have a P.O. box and no home delivery, enter your box number. | Apt. number

City, town or post office, state, and ZIP code. If a foreign address, enter city, province or state, and country. Follow the country's practice for entering the postal code.

2 If this address is new since you filed your last tax return, check here . . . . . ▶ ☐

3 ( ) Your home phone number | Best time for us to call

4 ( ) Your work phone number | Ext. | Best time for us to call

5 Name of your bank or other financial institution:

Address

City, state, and ZIP code

6 Your employer's name:

Address

City, state, and ZIP code

7 Enter the tax return for which you are making this request (for example, Form 1040) . . . . . ▶

8 Enter the tax year for which you are making this request (for example, 2003) . . . . . ▶

9 Enter the total amount you owe as shown on your tax return 9

10 Enter the amount of any payment you are making with your tax return (or notice). See instructions 10

11 Enter the amount you can pay each month. **Make your payments as large as possible to limit interest and penalty charges.** The charges will continue **until** you pay in full 11

12 Enter the date you want to make your payment each month. **Do not** enter a date later than the 28th. ▶

13 If you want to make your payments by electronic funds withdrawal from your checking account, see the instructions and fill in lines 13a and 13b.

▶ a Routing number

▶ b Account number

I authorize the U.S. Treasury and its designated Financial Agent to initiate a monthly ACH electronic funds withdrawal entry to the financial institution account indicated for payments of my Federal taxes owed, and the financial institution to debit the entry to this account. This authorization is to remain in full force and effect until I notify the U.S. Treasury Financial Agent to terminate the authorization. To revoke payment, I must contact the U.S. Treasury Financial Agent at **1-800-829-1040** no later than 7 business days prior to the payment (settlement) date. I also authorize the financial institutions involved in the processing of the electronic payments of taxes to receive confidential information necessary to answer inquiries and resolve issues related to the payments.

Your signature | Date | Spouse's signature. If a joint return, **both** must sign. | Date

The IRS seized Mary Germaine's 1989 and 1990 income tax refunds and sent notice of intent to levy for prepetition taxes, after Germaine had filed a chapter 13 petition and completed her plan of reorganization in March 1990. Germaine filed a motion directing the IRS (1) to permanently abate collection of 1981 FUTA taxes she allegedly owed, to bar the IRS from auditing her prepetition taxes, and (2) to return her 1990 income tax refund. This case was settled by an agreement that the IRS would abate the collection of the 1981 FUTA taxes, return the 1990 refund, and treat all taxes that accrued prior to the date of the chapter 13 petition as paid in full or discharged.

Germaine also moved for attorney's fees and costs. The bankruptcy court found that it had jurisdiction to hear the claim for attorney's fees because the claim arose out of the same transaction as the IRS's claim against Germaine. The court also held that because she had exhausted her administrative remedies and the government's position was not substantially justified, she was entitled to $2,000 in attorney's fees.

On appeal, the Ninth Circuit BAP affirmed the award for damages against the IRS.[421] A bankruptcy appellate panel of the Ninth Circuit, in affirming the bankruptcy court decision, held that Bankruptcy Code section 106(a) did not apply to waive the IRS's sovereign immunity as to Germaine's claim for damages because the cause of action against the IRS belonged to the debtor, rather than to the estate, and because the IRS's claim was not against the bankruptcy estate.

In *Henry Robert Grewe*,[422] the bankruptcy court allowed damages in a chapter 7 case where the taxes were discharged.

Section 1328(b) of the Bankruptcy Code provides for an early discharge of debts that were scheduled for payment in the plan if the debtor is, under certain conditions, unable to make these payments. The provisions of Bankruptcy Code section 523(a) are fully applicable to this subsequent discharge, which means that taxes with priority are exempt from discharge, as are taxes resulting from the misconduct of the debtor.

On appeal, the Fourth Circuit determined that the Grewes were not entitled to recover attorney's fees because they failed to exhaust their administrative remedies before filing suit in the bankruptcy court.[423]

In *In re Nelson*,[424] Terry Nelson filed for chapter 13 bankruptcy, and his plan of reorganization stated that the IRS priority tax claims were to be paid nothing. The IRS received notice of the bankruptcy and the motion for confirmation of the plan, but did not object to the plan before the bankruptcy court confirmed it. The plan was confirmed before the time for filing claims had expired. The IRS filed a timely tax claim. However, the district court affirmed the decision of the bankruptcy court that disallowed the claim of the IRS. The district court noted that the government admitted that the IRS chose not to respond after receiving adequate notice of confirmation of the proposed plan. This lack of response constituted tacit approval. The court also added that the IRS was not prejudiced by the procedure, but that dismissal of the bankruptcy case after it had been fully administered would have been highly prejudicial to the debtor and all the other creditors.

A couple's motion to reconsider the dismissal of their chapter 13 case was denied because their continued failure to file tax returns—despite being given ample opportunity to do so—indicated their lack of good faith.[425]

[421] *United States v. Mary Germaine*, 152 B.R. 619 (Bankr. 9th Cir. 1993).
[422] 148 B.R. 824 (Bankr. N.D. W. Va. 1992).
[423] *In re Grewe*, 4 F.3d 299 (4th Cir. 1993).
[424] No. 92-Z-2262 (D. Colo. July 25, 1994).
[425] *In re Tobias*, 200 B.R. 412 (Bankr. M.D. Fla. 1996).

A tax with respect to which the debtor made a fraudulent return or willfully attempted to evade or defeat such tax is dischargeable under the general chapter 13 discharge provision of section 1328(a) of the Bankruptcy Code.[426] The taxpayers filed a chapter 13 petition in January 1991, and subsequently their chapter 13 plan, which provided for full payment of all unsecured priority claims, was confirmed, but neither the original nor amended plan schedules provided for payment of the IRS's allowed claim for 1986 tax due on unreported income earned through embezzlement. The taxpayers argued that the IRS's unsecured claim was for tax due more than three years before the petition, and as a result no priority is granted tax debts arising from a fraudulent return. On the other hand, the IRS based its claim to priority status on the six-year exception of I.R.C. section 6501(e)(1)(A) to the general three-year assessment period for omissions of income greater than 25 percent of the income reported.

The bankruptcy court held that tax liabilities were not entitled to unsecured priority claim treatment and were dischargeable in a chapter 13 case, even though the debtors' return, filed less than six years before their bankruptcy filing, fraudulently contained a substantial omission of income. The bankruptcy court, quoting section 523(a)(1)(C) of the Bankruptcy Code, held that a tax with respect to which the debtor made a fraudulent return or willfully attempted to evade or defeat such tax is dischargeable under the general chapter 13 discharge provision of section 1328(a) of the Bankruptcy Code. The court noted that the result would be different in a chapter 7, 11, or 12 individual case, in which the liability would not be discharged and as a result the taxing authority could pursue a debtor after the bankruptcy case. The court found no ambiguity in Congress's intent to afford dischargeability under chapter 13. Thus, based on the plain language of section 507(a)(8)(A)(iii) of the Bankruptcy Code, which excepts from priority status tax of a kind specified in section 523(a)(1)(C), the bankruptcy court ruled that sections 507(a)(8)(A)(iii) and 523(a)(1)(C) of the Bankruptcy Code dictate that a tax resulting from fraud is not entitled to priority status, even though the tax might otherwise be assessable under the six-year statute of limitations for substantial omissions.

The Fourth Circuit, in a one-paragraph per curiam opinion, upheld the dismissal of a chapter 13 bankruptcy case, because the individual debtor failed to provide for full payment of a federal tax claim that was allowed in his chapter 13 plan.[427]

In *In re Hairopoulos*,[428] the debtor provided in the chapter 13 plan that all priority taxes were to be paid, but because the debtor did not file a proof of claim on a timely basis in this no-asset case, the tax was not allowed. The district court concluded that the tax debts were not provided for in the chapter 13 plan because the IRS had not received notice of the case in time to file a timely claim. On appeal, the Eighth Circuit held that a claim cannot be considered to have been *provided for* if a creditor does not receive proper notice of the proceedings. The court noted that the constitutional component of notice is based upon recog-

[426] *In re Zieg*, 194 B.R. 469 (Bankr. D. Neb. 1996); *aff'd* 206 B.R. 974 (D. Neb. 1997).
[427] *In re Lehnhardt*, 70 F.3d 1262, 1995 U.S. App. LEXIS 33152 (4th Cir. 1995).
[428] 118 F.3d 1240 (8th Cir. 1997).

nition that creditors have a right to adequate notice and the opportunity to participate in a meaningful way in the course of bankruptcy proceedings. The appeals court concluded that the no-asset notice given to the IRS was insufficient to satisfy due process and fundamental fairness. The court disagreed with the debtor that the IRS had a duty to seek leave to file a late proof of claim, because such a requirement would undermine "the very rationale for granting parties the right to participate in bankruptcy proceedings."

(viii) Postpetition, Preconfirmation Interest

Section 1141(d)(2) provides that the confirmation of a plan does not discharge an individual debtor from any debt excepted under section 523 of this title. Courts have interpreted this to suggest that it was congressional judgment that certain kinds of debts will remain nondischargeable even after the plan has been confirmed, despite the broad discharge allowed under section 1141(d)(1)(A). In *In re Grynberg*,[429] the Tenth Circuit held that the court is bound by congressional judgment placing a higher value on collection of revenue than rehabilitation of the debtor.

In *United States v. Gary Heisson*,[430] the district court held that the IRS may collect interest on prepetition claims from the individual debtor that is not allowed under the provisions of the Bankruptcy Code or not provided for in the plan, even though all nondischargeable debts are provided for under the plan. The debtors' chapter 11 plan provided for the payment of the IRS's nondischargeable tax claim of $26,000. After plan confirmation, the IRS informed the couple that it intended to seek postpetition, preconfirmation interest ("gap interest") outside the plan. The couple sought an injunction against the IRS barring it from collecting the interest.

The bankruptcy court denied the injunction but ruled that the couple was not liable for the gap interest because their plan proposed full payment of the IRS's nondischargeable tax claim. The district court, reversing the bankruptcy court, held that the couple is liable for postpetition, preconfirmation interest on the nondischargeable, prepetition tax debt owed to the IRS.

The bankruptcy court reasoned that 11 U.S.C. section 1141(d)(2) was irrelevant to this situation; that statute provided that debts excepted from discharge by 11 U.S.C. section 523 are also not discharged upon plan confirmation. However, the district court said that the bankruptcy court diminished the intended effect of section 1141(d)(2) by making dischargeable that which Congress intended to make nondischargeable. The district court noted that this section reflects the intent of Congress that certain debts remain nondischargeable after plan confirmation. The district court relied on *Bruning v. United States*,[431] in which the Supreme Court held that gap interest on a nondischargeable debt is nondischargeable, even if the underlying claim is paid in full by the bankruptcy estate.

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[429] 986 F.2d 367, 371 (10th Cir. 1993).
[430] 217 B.R. 1 (D. Mass. 1997).
[431] 376 U.S. 358 (1964).

Under the Bankruptcy Act, gap interest allowed on nondischargeable debt was likewise nondischargeable whether or not the underlying claim was paid in full by the bankruptcy estate. The district court in *Heisson* held that if Congress had intended to change that rule under the Bankruptcy Code, it would have made that intent clear in the language of the statute. The Ninth Circuit adopted the reasoning in *Heisson* and held that the individual is liable for the interest.[432]

Decisions under the Bankruptcy Code, based on nondischargeable debts that were not fully paid, also support the holdings in *Bruning*.[433]

The district court rejected the conclusion of the bankruptcy court that *Bruning* did not apply to *Heisson* because it dealt with nondischargeable claims that were only partially paid in the bankruptcy proceeding, whereas, under *Heisson*, the claims are to be fully paid in the bankruptcy proceedings. The district court cited several circuit courts, all of which were pre-Code, that had rejected this distinction altogether.[434]

The district court in *Heisson* also disagreed with the lower court that section 502(b)(2) prevents creditors from collecting gap interest from debtors on nondischargeable debt, reasoning that the term "claim" as used in that section does not require the allowance of a proof of claim to establish a claim's existence.

(c) Corporate Debtors

Section 727 of the Bankruptcy Code prohibits the granting of a discharge to a corporation in a chapter 7 liquidation. Also, a corporation liquidating under a plan adopted in a chapter 11 case would not obtain a discharge. Because a corporation in effect goes out of business as a result of the liquidation, it might appear that the actual granting of a discharge is unimportant. A corporation, however, does not have to go out of existence, and shareholders have kept these shells alive so they could be reactivated at a later date for tax reasons or to avoid the costs of creating another corporation. A debtor will be reluctant to use these shells under the current bankruptcy law, because any assets owned by the corporation are subject to attachment by the creditors for prebankruptcy debts.

Section 1141(d) of the Bankruptcy Code states that, in a chapter 11 case, unless otherwise provided, confirmation of the plan discharges the corporate debtor from any debt that arose before the date of confirmation. This would include all taxes that have not been paid, including taxes attributable to no

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[432] *In re Artisan Woodworkers*, 204 F.3d 880 (9th Cir. 2000).

[433] *See, e.g., Leeper v. Pennsylvania Higher Educ. Assistance Agency*, 49 F.3d 98, 104 (3d Cir. 1995); *In re Fullmer*, 962 F.2d 1463, 1468 (10th Cir. 1992); *In re Burns*, 887 F.2d 1541, 1543 (11th Cir. 1989); *In re Hanna*, 872 F.2d 829, 831 (8th Cir. 1989); *In re Willauer*, 192 B.R. 796, 801 n.4 (Bankr. D. Mass. 1996); *In re JAS Enters.*, 143 B.R. 718 (Bankr. D. Neb. 1992); *In re Fox*, 130 B.R. 571, 575 (Bankr. W.D. Wash. 1991). *But see In re Wasson*, 152 B.R. 639, 642 (Bankr. D.N.M. 1993).

[434] *United States v. River Coal Co.*, 748 F.2d 1103, 1107 (6th Cir. 1984); *Eby v. United States*, 456 F.2d 923, 925 (3d Cir. 1972); *In re Johnson Elec. Corp.*, 442 F.2d 281, 283-84 (2d Cir. 1971).

returns, late returns, or fraudulent returns. It should be noted, however, that before a plan will be confirmed, taxes with priority must be paid or provided for in full (see § 11.2(m)). Thus, in reality the only taxes that can be discharged in a corporate reorganization are those that do not have priority. Bankruptcy Code section 1106(a)(6) provides that the trustee, in situations where the debtor did not file a tax return required by law, must furnish, without personal liability, the information that the government may require regarding prepetition liabilities arising from periods where the required returns were not filed. The conference explanation indicates that the tax authority may disallow any tax benefit claimed subsequent to the reorganization if it results from a deduction, credit, or other item improperly reported prior to the filing of the petition.[435]

As was noted above, unless otherwise provided in the plan, section 1141(d) of the Bankruptcy Code provides that the confirmation of a chapter 11 plan discharges the debtor of any debt that arose before the date of confirmation. Section 1129(a)(9) of the Bankruptcy Code provides that taxes with priority must be provided for in the plan. Payment may be deferred over 6 years from the date of assessment.[436] Listed below are some examples in chapter 11 cases where a tax claim that is a priority tax may be discharged or disallowed:

- The IRS failed to file a timely proof of claim.[437] However, failure to give proper notice may result in the allowance of the tax claim even though a proof of claim was not timely filed.[438]
- The IRS failed to respond to the objection of the trustee.[439] Improper notice to the IRS or no notice at all may result in the tax being allowed and thus not dischargeable.[440] Bankruptcy Rules 9014 and 7004(b) contain the procedures that should be followed in giving notice.
- Generally, the courts will allow the IRS to amend a timely filed proof of claim after the bar date even if it is for another year.[441]

The IRS was not allowed to amend to include another year (1981) in its 1983 proof in *United States v. Howard E. Owens.*[442] The district court noted that the bankruptcy court cited three factors it had considered:

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[435] 124 Cong. Rec. 5-17431. *See* Bacon and Billinger, *supra* note 1, at 79.
[436] *See In re Camino Real Landscape Corporation, Inc.*, 818 F.2d 1503 (9th Cir. 1987).
[437] *In re Holywell Corp.*, 85 B.R. 898: 88-1 USTC (CCH) ¶ 9351 (Bankr. S.D. Fla. 1989).
[438] *In re Allan Ray Johnson*, 95 B.R. 197 (Bankr. D. Colo. 1989) (a chapter 13 case).
[439] *In re Hunt Brothers Construction*, Inc., 1989 Bankr. LEXIS 2022 (Bankr. D. Idaho 1989)(a chapter 11 case later converted to chapter 7).
[440] *See In re Richard J. Morrell*, 87-1 USTC (CCH) ¶ 9142 (N.D. Ga. 1986); *In re F.C.M. Corp.*, 1987 U.S. Dist. LEXIS 15275 (S.D. Fla. 1987); *In re Ronald Elsworth Reichard*, No. B-3-86-02362; LEXIS 88 TNT 203-26 (Bankr. S.D. Ohio 1988). *But see In re Cardinal Mine Supply, Inc.*, 1988 Bankr. LEXIS 2594 (Bankr. E.D. Ky. 1988).
[441] *See In re Homer R. Birchfield*, No. 5-87-00259; LEXIS 88 TNT 107-19 (Bankr. W.D. Va. 1988).
[442] 84 B.R. 361 (E.D. Pa. 1988).

1. The absolute nature of the policy barring late filings;
2. The failure of the IRS to ask for an extension;
3. The equitable factors enunciated in *In re Miss Glamour Coat Co., Inc.*[443]

The court emphasized, however, that the first two factors alone were enough to justify the preclusion of the tax liability for 1981 for which a proof of claim was not filed.

The IRS was also not allowed to amend its return in a chapter 11 case where the IRS had failed to state in its original claim that it was an estimate and did not inform the debtor that it would be assessing a much more significant claim.[444]

[443] 80-2 USTC (CCH) ¶ 9737 (S.D.N.Y. 1980).
[444] *In re S.T. Patrick*, 96 B.R. 358 (Bankr. M.D. Fla. 1989).

CHAPTER TWELVE

Tax Preferences and Liens

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§ 12.3 Tax Liens **646**

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§ 12.1 INTRODUCTION

In a bankruptcy case, federal and state and local tax liens are handled differently under certain circumstances than they would be in an out-of-court case. Also, tax payments made within 90 days prior to bankruptcy may be avoided. The objective of this chapter is to examine the issues associated with tax preferences and liens.

§ 12.2 TAX PREFERENCES

(a) General Provision

The payment of a past due tax to a governmental unit can be considered a preferential payment under certain conditions. Section 547(b) of the Bankruptcy Code provides that any transfer of property of the debtor, while insolvent, in payment of an antecedent debt owed by the debtor to an unsecured creditor may be avoided if made within 90 days before the petition is filed.

The bankruptcy court held that chapter 13 debtors have standing to pursue the avoidance of an allegedly preferential transfer, that a federal tax lien has priority over a bank's security interest, and that a prepetition payment to the bank

was an avoidable preferential transfer.[1] The bankruptcy court, noting that the trustee had refused to pursue the matter, and reasoning that a secured creditor should not retain an advantage over other creditors when it had not perfected its lien, held that the debtors may prosecute these claims so long as any recovery is deposited with the trustee.

When determining when a tax claim is incurred for preference purposes, a special rule applies: Section 547(a)(4) states that "a debt for a tax is incurred on the day when such tax is last payable without penalty, including any extension."

Thus, for purposes of determining the preference of an employment tax it is the date when the tax claims first became subject to a penalty for its failure to deposit with a qualified depository institution the taxes it later paid to the IRS. The district court[2] rejected the Service's position that the return is due on the date that it is due, which for the first quarter of the year would be April 30 and not the date that the deposit was made. It is the date that the debtor is exposed to the penalty and not the date that the penalty is actually assessed or the date on which the quarterly return is due.

(b) Chapter 7 Liquidation Requirement

The avoidance of a preference is based on the assumption that the creditor received more as a result of the transfer than would have been received if the case were under chapter 7. In *Tenna Corp.*,[3] it was determined that the payment of federal income tax deficiencies 2 months before filing a chapter 11 petition was a preferential payment and that the amount that the government repaid was subject to statutory interest. This decision was reversed by the Sixth Circuit on the ground that the IRS did not receive more than would have been received in a chapter 7 liquidation.[4] The district court held that, in determining whether the debtor received more than would have been received in a chapter 7 liquidation, all events occurring after the petition is filed, up to the date of the hearing on the issue, are considered. The Sixth Circuit, in reversing the district court's decision, held that postpetition debt should not be considered in determining whether the creditor received more than would have been received in a chapter 7 liquidation.

It should be realized that courts have not followed the *Tenna* decision where the preference action related to a contract that was subsequently assumed.[5]

The bankruptcy court ruled, in *In re Healthcare Services*,[6] that a preferential transfer occurred when the IRS seized approximately $295,000 from the company's bank account. The court concluded that, because administrative

[1] *In re Straight*, 200 B.R. 923 (Bankr. D. Wyo. 1996).

[2] *In re Pullman Constr. Indus.*, 210 B.R. 302 (N.D. Ill. 1997). *See In re Harvard Mfg. Corp.*, 97 B.R. 879 (Bankr. N.D.Ohio 1989), *In re E & S Comfort, Inc.*, 92 B.R. 616 (Bankr. E.D. Pa. 1988); and *In re American Int'l Airways, Inc.*, 83 B.R. 324 (Bankr. E.D. Pa. 1988).

[3] 86-2 USTC (CCH) ¶ 9675 (D.C. Ohio 1986).

[4] 801 F.2d 819 (6th Cir. 1986).

[5] See *In re Superior Toy & Manufacturing Co.*, 78 F.3d 1169 (7th Cir. 1996); *Seidle v. GATX Leasing Corporation*, 778 F.2d 61159, 660 (11th Cir. 1985) and *Alvarado v. Walsh* (*In re LCO Enterprises*), 12 F.3d 938, 940 (9th Cir. 1993).

[6] 80 B.R. 563 (Bankr. N.D. Ga. 1987).

expenses and employee benefit claims have a greater priority than seventh-priority tax claims, the IRS received more than it would have received in a chapter 7 liquidation.

(c) Ordinary Course of Business

A transfer is not, however, avoided if the payment was made in the ordinary course of business according to ordinary business terms. For petitions filed prior to October 8, 1984, it was also necessary that payment be received within 45 days after the debt was incurred to meet the ordinary business exception. The Bankruptcy Amendments and Federal Judgeship Act of 1984 eliminated the 45-day requirement. For tax purposes, the date the debt was incurred is, according to Bankruptcy Code section 547(a)(4), the day when such tax is last payable, including any extensions, without penalty. Thus, the trustee or debtor-in-possession could recover a tax paid within the last 90 days. In *In re Greasy Creek Coal Co.,*[7] the bankruptcy court held that a trustee may avoid transfers to the government if all the statutory requirements are met and if the transfer is not excepted from the avoidance rules. In this case, the transfer did not qualify as an exception because it was made more than 45 days after taxes were payable without penalty and because the court determined that the transfer was not made in the ordinary course of business. The debtor used money transferred by a third party and intended as a payroll advance to pay withholding taxes, and payment was made in the form of a third-party check.

In *Union Bank v. Wolas,*[8] the Supreme Court held that timely payments and interest under a long-term note are not preferences. Thus, payments made under a long-term agreement with the IRS or other taxing agencies would not be a preference even if made within 90 days prior to the petition date.

(d) Withholding Taxes: Property of the Estate?

In the Ninth Circuit, it was held in *In re R&T Roofing Structures*[9] that trust funds could be recoverable as preferences under some circumstances. R&T Roofing (R&T) failed to pay to the IRS taxes withheld from its employees' wages during the last quarter of 1979. On October 23, 1980, well over 45 days after the due date of the taxes, the government seized money from R&T's general operating account to satisfy a tax lien. On January 9, 1981, less than 90 days after the seizure, and more than 90 days after the lien had been perfected, R&T filed a chapter 7 petition. The bankruptcy court ruled that the tax claims were recoverable as preferential transfers.

On appeal to the district court, the government argued that the seized funds had been held in trust for the government under I.R.C. section 7501, which impresses a statutory trust on withheld taxes. The district court rejected this argument because there was no segregation of assets indicating a trust.

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[7] 84-2 USTC (CCH) § 9651 (Bankr. S.D. W. Va. 1984).

[8] 112 S. Ct. 527 (1991).

[9] 887 F.2d 981 (9th Cir. 1989).

The court also relied on *United States v. Randall*[10] to hold that the priority provisions of the Bankruptcy Code superseded I.R.C. section 7501.

On appeal, the Ninth Circuit held that, where a seizure by the government of money owed for taxes was not made within 45 days of the due date, the payment was voidable in bankruptcy as a preferential transfer unless the government could trace the payment to unpaid taxes. The Ninth Circuit rejected the IRS's argument (which the Supreme Court accepted, as discussed below) that the Bankruptcy Code was intended to relax the tracing requirements in Randall.

The Ninth Circuit adopted the analysis in *Drabkin v. District of Columbia,*[11] which concluded that the timing of the debt was the crucial factor in determining whether a payment would be potentially voidable. Late payments would be for antecedent debts and would be voidable as preferential transfers unless they could be traced by the government to unpaid taxes.

However, the Supreme Court agreed with the Third Circuit, in *Harry P. Begier, Jr.,*[12] and ruled that taxes are held in trust for the government and are not subject to recovery.

During the spring of 1984, American International Airways, Inc. (American) became delinquent in remitting social security, withholding, and airline passenger excise taxes. As a result, the IRS required American to file monthly returns and deposit the taxes in trust for the IRS in a separate bank account.

In April 1984, American paid the IRS $695,000 from the trust account and $734,798 from the company's general operating account. Additional payments from its general operating account were made in June 1984, resulting in a total of $946,434 being paid from the general fund.

The Third Circuit, in a split decision, reversed the decision of the bankruptcy court and the district court, ruling that prepetition payments on account of tax withholding obligations are held in trust for the government and are not preferential transfers. No distinction was made for deposits in a special trust fund. The court ruled that the legislative history of section 547(b) of the Bankruptcy Code suggests that Congress intended that withholding taxes be considered as funds held in trust. The funds are not property of the estate, and thus are not subject to the preferential transfer rules.

The Supreme Court held, without dissent, that the payment of trust-fund taxes to the IRS from general accounts were not transfers of "property of the debtor," but were instead transfers of property held in trust for the government pursuant to I.R.C. section 7501. As a result, the Court concluded that such payments cannot be avoided as preferences. The Court rejected the argument that a trust was never created because the funds were not segregated under I.R.C. sections 7501 and 7512. The bankruptcy judge in *In re Dr. Rene R. Rodriguez*[13] held that withholding taxes were held in trust and were not within the reach of section 547 of the Bankruptcy Code.

[10] 401 U.S. 513 (1971).
[11] 824 F.2d 1102 (1987).
[12] 496 U.S. 53 (1990), *aff'g* 878 F.2d 762 (3d Cir. 1989).
[13] 50 B.R. 576 (Bankr. E.D. N.Y. 1985).

The bankruptcy court held that a prepetition payment of withholding taxes did not constitute an avoidable preference.[14] The corporation used $498,000, part of the proceeds from the sale of collateral, to settle a tax lien of $897,000 with the IRS. The IRS allocated $478,000 to trust fund taxes and $19,000 to nontrust fund taxes. The bankruptcy court concluded that of the $497,000 payment, $478,000 was not a preferential payment under *Begier,* but that the $19,000 portion representing nontrust fund taxes was a preferential transfer.

In *United States v. Pullman Construction Industries, Inc.,*[15] the district court affirmed a bankruptcy court's decision that three of a company's eight prepetition payments to the IRS were recoverable as preferential transfers. The court also held that the date the debt is incurred is the date that the deposit is due, not the date that the return is due. The court noted that under section 547(a)(4) of the Bankruptcy Code, a debt for a tax is incurred on the day when such tax is last payable without penalty. Only nontrust fund payments were considered preferences.

A federal district court[16] held that the IRS's levy on a debtor's bank account to collect outstanding employment taxes was avoidable as a preferential transfer under *Begier.* In 1992, Ruggeri Electrical Contracting, Inc., became delinquent in paying employment taxes, owing $150,000 by the third quarter of 1992. In September, Ruggeri entered a $5,000-per-month installment agreement with the IRS, which it kept current until March 1993. In April 1993, the company terminated its business operations, and in May it paid $60,000 to the IRS.

The IRS issued a levy notice in August; at that time, Ruggeri owed $196,000 of employment taxes. A few weeks later, several of Ruggeri's creditors filed an involuntary bankruptcy petition against it. Ruggeri's bank transferred the company's $54,000 account balance to the bankruptcy trustee, Paul Borock. The bankruptcy court ruled that the $54,000 did not become property of the estate because Ruggeri did not retain any interest in the funds.[17] In a subsequent hearing, the court ruled that the levy did result in a preferential transfer because the IRS had failed to demonstrate a sufficient nexus between the section 7501 trust and the funds seized, under *Begier*.[18]

The district court stated that, under *Begier,* it must conduct a two-pronged inquiry to determine whether the levy was a preferential transfer: (1) did a trust for the IRS exist, and, if so, (2) was the $54,000 part of that trust? As to the first prong, the district court concluded that a trust did exist, explaining that a trust is created when a debtor pays its employees and withholds taxes. With respect to the second prong, however, the court found that the funds Ruggeri withheld from its employees' wages did not have a reasonable nexus with the $54,000 paid to the IRS.

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[14] *In re Jones & Lamson Waterbury Farrel Corp.*, 208 B.R. 788 (Bankr. D. Conn. 1997).
[15] No. 96 C 1196 (N.D. Ill. June 9, 1997).
[16] *In re Ruggeri Elec. Contracting*, 214 B.R. 481 (E.D. Mich. 1997).
[17] *See In re Ruggeri Elec. Contracting, Inc.,* 185 B.R. 750 (Bankr. E.D. Mich. 1995).
[18] *See In re Ruggeri Elec. Contracting, Inc.*, 199 B.R. 903 (Bankr. E.D. Mich. 1996); *aff'd* 214 B.R. 481 (E.D. Mich. 1997).

The district court reasoned that Ruggeri, unlike the debtor in *Begier,* did not make a voluntary payment of the disputed funds, and the court noted that the IRS had conceded that a levy does not constitute a voluntary payment. The district court also refused to extend *Begier* to involuntary tax payments.

The Eighth Circuit, reversing a district court decision, held that a pension plan's receipt of $6 million of benefits payments within 90 days before an employer's bankruptcy is not an avoidable preference.[19] In May 1991, after failing to make pension and welfare plan contributions, Jones Truck Lines, Inc. and the fund negotiated an agreement under which Jones delivered $2.9 million in promissory notes to the fund and agreed to pay its current plan contributions on a weekly, rather than a monthly, basis. From April to July, Jones paid $6 million to the fund; no part of these payments was applied to the promissory notes. In July, Jones filed for relief under chapter 11 and attempted to recover the $6 million as preferential payments. The bankruptcy and district courts held that the payments were preferential, rejecting the fund's contention that the contributions were not avoidable because Jones received contemporaneous new value under 11 U.S.C. section 547(c)(1). The Eighth Circuit held that new value was received in the form of the services its employees continued to provide within the 90-day, prebankruptcy period. The court further concluded that the parties intended a contemporaneous exchange and that the exchange was in fact substantially contemporaneous.

(e) Statutory Lien

Section 547(c)(6) of the Bankruptcy Code provides that the fixing of a statutory lien is not a preference. Thus, the creation or perfecting of a tax lien is not a preference item unless the lien is not properly perfected. Section 545 of the Bankruptcy Code provides that the trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists. For example, a bankruptcy court held that tax liens arising out of various employer taxes for which the debtors were responsible are statutory liens and these cannot be avoided under Bankruptcy Code section 545.[20] The court held that a prepetition penalty could be avoided to the extent the penalty was not compensation for actual pecuniary loss.

In *In re Robert F. Totten,*[21] the bankruptcy court held that a federal tax lien established before an individual declares bankruptcy may not be avoided by the trustee as a preferential transfer. In May and June 1987, the IRS filed notices of federal tax lien against the taxpayer, Robert Totten. In July 1987, Totten filed for bankruptcy. The trustee then sought to avoid the tax liens as preferential transfers under 11 U.S.C. section 547. The court concluded that a tax lien properly filed before the bankruptcy petition is filed is not included among the statutory

[19] *In re Jones Truck Lines, Inc.*, 130 F.3d 323 (8th Cir. 1997).
[20] *In re Barry*, 31 B.R. 683 (Bankr. S.D. Ohio 1983).
[21] 82 B.R. 402 (Bankr. W.D. Pa. 1988). *See also In re Barry*, 31 B.R. 683 at 685.

liens that may be avoided as preferential transfers. The bankruptcy court[22] noted that IRS liens arising by virtue of I.R.C. section 6321 are statutory liens. Such liens may be perfected by filing in the Court of Common Pleas in accordance with the provisions of section 6323(f). Thus the IRS filed notice of its lien in the Court of Common Pleas for Dauphin County, Pennsylvania, on March 25, 1992, one and one-half months prior to the filing of Debtors' petition for relief under chapter 7. Under these circumstances, the lien is not avoidable under section 547(b), because section 547(c)(6) prevents it from being avoided as it is not the type of statutory lien avoidable under section 545.

The bankruptcy court held that a transfer of funds to the IRS under a levy served less than 90 days before a debtor filed his chapter 7 petition was not avoidable as a preference.[23] The taxpayer argued that his insolvency at the time of the levy brought the levy within the provision of section 545(1)(D) of the Bankruptcy Code for a statutory lien that first becomes effective when the debtor becomes insolvent, and that an IRS lien or levy therefore fell outside the safe harbor available to creditors under 11 U.S.C. section 547(c)(6).

The bankruptcy court held that a federal tax lien or levy does not become effective against a debtor upon his insolvency, but rather when either demand for payment of tax is made or the levy is served.

In another case, within 90 days before the debtor filed his chapter 13 petition, the IRS garnished the taxpayer's bank account.[24] The bankruptcy court noted that although there was no evidence that the lien had been perfected by the filing of a notice, the lien was perfected by attachment and seizure of the bank account. The seizure was not avoidable under section 545 or 547(c)(6) of the Bankruptcy Code, and because a tax lien is a statutory, rather than judicial, lien, the garnishment could not be avoided under section 522(f)(1) of the Bankruptcy Code. Section 522(f)(1), according to the bankruptcy court, applies only to judicial liens.

In a legal memorandum, Mitchell S. Hyman, senior technician reviewer, branch 2 (general litigation), concluded that payments of nontrust fund taxes, whether voluntary or involuntary, may be avoided by a chapter 7 trustee and brought back into the bankruptcy estate.[25] However, Hyman noted that the voluntary but undesignated payments and involuntary payments that the Service applies to trust fund taxes also are not property of the debtor, but are held in trust for the United States under I.R.C. section 7501, and therefore, are not avoidable by the trustee.

[22] *In re Wiles*, 173 B.R. 92 (Bankr. M.D. Pa, 1994). see also *Fandre v. Internal Revenue Service*, 167 B.R.7 (Bankr. E.D. Tex. 1994); *In re J.B. Winchells, Inc.*, 106 Bankr. 384, 390-91 (Bankr. E.D. Pa. 1989).
[23] *In re Gillenwater*, 1996 Bankr. LEXIS 428 (Bankr. W.D. Va. 1996).
[24] *In re Filipovits*, 1995 Bankr. LEXIS 1447 (Bankr. D. Md. 1995).
[25] ILM 200029002 (Feb. 29, 2000).

§ 12.3 TAX LIENS

(a) Introduction

It is not unusual for the debtor in a bankruptcy case to discover that some or all of the debtor's property is subject to either federal or state and local tax liens, or both. Interests in property in a bankruptcy case are generally governed by state statutes; however, federal laws determine the validity and enforceability of federal tax liens. State and local tax liens are governed by state statutes.

(b) Federal Tax Liens

A federal tax lien is created under I.R.C. section 6321 when a tax assessment has been made, notice has been given of the assessment, stating the amount and demanding its payment, and the amount assessed is not paid within 10 days after notice and demand. Once these events have occurred, a tax lien is imposed against all property and rights to both real and personal property that belong to the debtor on the assessment. These liens are regarded as "secret liens" because public notice of the lien is not required. Only the taxpayer is aware of the assessment and the demand for payment.

However, for the IRS to have priority over the interests of other creditors, especially in a bankruptcy case, the IRS will need to file a notice of lien. I.R.C. section 6322 provides that the lien arises at the time the tax is assessed, unless another date is specifically fixed by law, and continues until the amount assessed is collected or becomes unenforceable. The lien generally becomes unenforceable after 10 years from the assessment. The securing of a personal judgment against a taxpayer for back taxes does not extend or curtail the 10-year collection period beginning on the assessment.[26]

Section 6502 of the Internal Revenue Code provides that, where the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun within ten years after the assessment of the tax.

In November 1990, the time period was extended from six years to ten years. Thus, for all assessments that were made more than six years prior to November 1990, the six-year period would apply.

The bankruptcy court[27] held that the IRS lien arose at the time the jeopardy tax assessment was made, as provided in I.R.C. section 6322, and that the lien is valid in bankruptcy because it was recorded before the bankruptcy petition was filed.

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[26] The Revenue Reconciliation Act of 1990 increased the statute of limitations on collections from 6 to 10 years in I.R.C. section 6502(a)(1). The 10-year period applies to all taxes assessed after the enactment of the Act and any taxes assessed before the date of enactment, provided the statute of limitations on collections had not expired.

[27] *In re Gibout*, 2000 Bankr. LEXIS 918 (Bankr. E.D. Mich. 2000).

In *In re Dakota Industries, Inc.,*[28] it was held that the effective date provision of the federal tax collection statute of limitations has been construed to mean that if a tax would be discharged as computed by the six-year period as of the November 1990 effective date of the extended statute of limitations, the tax was subject to the six-year limitation period. In the event that the tax would not be discharged as computed by the six-year period, the tax was subject to the ten-year limitation period.

In *In re Babich,*[29] the bankruptcy court held that the IRS was precluded from pursuing its claims for the 1978, 1979, and 1980 tax years because it did not complete filing tax liens for the liabilities for those years until 30 days after expiration of the six-year limitation period. Although the IRS filed the notice of tax lien for the 1977 liability within the six-year limitation period, the IRS was not allowed to pursue collection because the first attempt to collect the liability was not made until 1991.

The court in *Babich* noted that there are four sets of circumstances that will affect the tolling of the statute of limitations:

- Appropriate action, if any, taken by the IRS within the statutorily applicable time; for example, the filing of a tax lien.
- Filing of bankruptcy within the statutorily applicable time.
- Debtors' engaging in fraudulent activities.
- Debtors and the IRS agreeing to extend the collection period.

The court then held that the IRS was barred from collecting debtors' 1978, 1979, and 1980 tax liabilities because of its failure to act within the attendant statute of limitations.

Following *In re Priest,*[30] the bankruptcy court held, in *United States v. Donald E. Morris,*[31] that the government liens were not valid until all the administrative steps necessary to create the lien were completed.

Under state law, if additional action must be taken by the state, the lien does not become effective until such action is taken. For example, in *In re Mctyre Grading & Pipe,*[32] the ad valorem taxes of Cobb County and Powder Springs arose and attached upon the date of valuation; however, those taxes did not become choate until the county's tax digest was approved by the State Revenue Commissions as required by Georgia law because the amount of the tax is subject to change until the tax digest is approved. Thus, Cobb County's lien for ad valorem taxes became choate when the tax digest was approved.

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[28] 131 B.R. 437 (Bankr. D. S.C. 1991).
[29] 164 B.R. 581(Bankr. D. Ohio 1993).
[30] 712 F.2d 1326 (9th Cir. 1983).
[31] No. CV-F-87-314; LEXIS, 89 TNT 191-19 (E.D. Cal. 1989).
[32] 193 B.R. 983; (N.D. Ga. 1996).

In *In re Cecilia Ann Pardue,*[33] the bankruptcy court held that perfection of a tax lien is only required to preserve priority and validity against third parties. The court noted that perfection does not affect whether the tax lien is valid.

In this chapter 13 case, the IRS filed a timely proof of claim for unpaid income taxes. The proof of claim was filed as secured to the extent of the value of the personal property listed in the schedules filed by the debtor. Pardue objected to the IRS's secured claim, arguing that because the IRS failed to file its notice of lien in the proper location, a lien was invalid because it was unperfected. As noted, the court denied Pardue's objection.

The state in which the property of the taxpayer is located dictates where the notice of a tax lien is filed (for example, state, county, or other governmental office). If the state fails to designate an appropriate central filing location, the notice of tax lien may be filed in the office of the clerk of the U.S. District Court.[34] If real estate is involved, the notice of tax lien is filed in the state or county where the real property is located. Where personal property is involved, the notice is filed in the state of residence of the taxpayer. A lien on personal property held by a corporation is filed in the appropriate location in the state where the business is incorporated.

Form 668, Notice of Tax Lien, is used by the IRS. This form explains the type of tax involved, the date of assessment, the unpaid balance, the interest, and the penalty amount. The form does not specifically mention the property to which the lien applies, because the IRS takes the position, based on I.R.C. section 6321, that the lien is applicable to all property (real or personal) of the taxpayer. In *21 West Lancaster Corp. v. Main Line Restaurant,*[35] the court held that a liquor license was property that was subject to a federal tax lien, even though under state law the license was not assignable, attachable, or subject to claims from state law creditors, because I.R.C. section 6331 provides that a federal lien attaches to property rights that may not be attached under state law.

The first-in-time, first-in-right rule applies in determining whether a federal tax lien has priority over state tax liens, as determined in *In re Shea-nanigan's, Inc.*[36]

Shea-nanigan's, Inc. filed a chapter 7 bankruptcy petition in November 1988. The corporation's liquor license was transferred to the bankruptcy trustee as property of the estate. The trustee filed a notice of her intention to sell the license. The bankruptcy court confirmed the sale, reserving for later determination the issue of the priority of liens on the liquor permit and sale proceeds asserted by the IRS and the Ohio Department of Taxation. Both the Department of Taxation and the IRS filed proofs of claim. In October, just prior to the filing of the chapter 7 bankruptcy petition, the IRS filed a notice of tax lien against Shea-nanigan's. The Department of Taxation argued that a liquor

[33] No. 91-90151 (Bankr. E.D. Cal. Oct. 15, 1992). *See Cannon Valley Woodwork, Inc. v. Malton Construction Co.*, 866 F. Supp. 1248, 1250 (D. Minn. 1994) ("Minnesota's statute does not require the commissioner to make a formal assessment and demand for unpaid taxes before the state has a lien against the taxpayer's property").

[34] I.R.C. § 6323(f)(1).

[35] 790 F.2d 354 (3d Cir. 1986).

[36] No. 588-2046 (Bankr. N.D. Ohio Jan. 3, 1991).

license is not property to which a federal tax lien can attach. The Department of Taxation also argued that a liquor license cannot be transferred under Ohio law until all Ohio sales taxes are paid.

The bankruptcy court ruled that the federal tax lien has priority over the state tax lien. The court, in rejecting both arguments of the Department of Taxation, cited *In re Terwilliger's Catering Plus, Inc.*[37] The court applied the first-in-time, first-in-right rule and held that the IRS lien had priority.

The bankruptcy court held that under I.R.C. section 6322, the federal tax lien had priority over the Florida tax warrants because the federal tax lien arose when the tax was assessed, which was four days before the first tax warrant was recorded. The court noted that none of the exceptions of section 6323 that would require the United States to first file a notice of federal tax lien in order to have priority over the Florida's tax warrants apply because the state of Florida, as a holder of a tax warrant, is not a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor.[38]

In *In re Whyte*,[39] the bankruptcy court held that the IRS tax lien was junior to the assignment of rents from the real estate executed by Whyte in favor of First Federal Savings Bank of Indiana. The court noted that the tax lien did not attach to rent payments as they accrued because, at the moment a payment became due, it became personal property under Indiana law. The court concluded that, under Indiana law, the IRS would have had to file its notice of federal tax lien with the clerk of the U.S. district court to perfect a tax lien as to Whyte's personal property, which it had failed to do. The court noted that a tax lien for personal property must be filed with the clerk of the U.S. district court under I.R.C. section 6323(f)(1)(B). The court affirmed an earlier decision in which it had held that the assignment of rentals granted to First Federal a valid security interest in the accrued rentals that was, under Indiana law, superior to a subsequent judicial lien and thus met the requirements of I.R.C. section 6323(h)(1)(A).

The Sixth Circuit affirmed a district court judgment holding that a tax lien has priority over a judgment creditor's lien.[40] The court concluded that the judgment creditor's notice of lis pendens did not satisfy the state recording statute.

The Sixth Circuit found that under state law, a judgment creditor must file a notice of judgment lien to perfect its claim; even if the judgment is a foreign judgment, state law makes full faith and credit automatic upon proper registration. The court found no reason why the taxpayer could not have filed a notice of judgment lien when it filed the notice of lis pendens because under state law a notice of lis pendens cannot, independently, create a lien against property.

A notice of lis pendens simply gives notice of pending litigation. The Sixth Circuit noted that a notice of judgment lien, however, attaches to all of the judgment debtor's property but to no one piece of property in particular. Thus, filing a notice of judgment lien cannot cloud title of a property that is currently owned by an individual other than the judgment debtor or perpetrate a fraud upon the

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[37] 11 F.2d 1168 (6th Cir. 1990).
[38] *In re Clark*, 2000 Bankr. LEXIS 740 (Bankr. M.D. Fla. 2000).
[39] 164 B.R. 976 (Bankr. N.D. Ind. 1993).
[40] *Redondo Constr. Corp. v. United States*, 157 F.3d 1060 (6th Cir. 1998).

court because the judgment will not attach to property in which the judgment debtor has no ownership interest.

In *Annette Kilker v. Commissioner,*[41] the bankruptcy court held that there is no statutory requirement that the IRS deliver a notice to the taxpayer prior to filing the notice of a federal tax lien. The court refused to void the lien.

In *In re Varrell,*[42] the court held that the failure to record a lien in both a husband's and a wife's name did not make it invalid. The IRS recorded two notices of tax lien against William Varrell and the Mulberry Inn Restaurant and Lounge in 1990, to collect unpaid social security taxes. Varrell and his wife operated the restaurant under the name of Mulberry Inn and they filed a chapter 13 petition in 1991. The IRS filed an amended secured proof of claim for the unpaid taxes. The Varrells challenged the secured status of the IRS lien.

The Varrells argued that the security was invalid because the notices of federal tax lien were filed solely in William Varrell's name, and the property was held by the Varrells in tenancy by the entirety. They contended that, under Florida law, property held in tenancy by the entirety can be reached only by a joint creditor of both spouses.

The bankruptcy court ruled that it is irrelevant in whose name the notices were filed, because the lien arose automatically upon the assessment, notice, and demand for payment of the taxes. The court concluded that, because the notices reflected two taxpayers (William Varrell and Mulberry Inn) and both William and his wife did business as Mulberry Inn, both of them may be liable for the taxes, depending on whether they were partners or joint ventures in the restaurant. The court also noted that, even if the IRS lien could not attach to the Varrells' property prepetition (because of the tenancy by the entirety), the claim would be converted to an unsecured priority claim.

An incorrectly identified tax year in a notice of tax lien was a minor defect, insufficient to void the lien or the notice, and an IRS lien may reach property exempt from levy under I.R.C. section 6334(a)(7). The Fifth Circuit stated that the error in tax year was a minor error in an otherwise properly filed notice and that the notice therefore gave constructive notice sufficient to comply with I.R.C. section 6323(f) and section 522(c)(2)(B) of the Bankruptcy Code.[43]

The premature distribution penalty does not apply to Keogh and IRA funds withdrawn to satisfy federal tax liens, according to the bankruptcy court. In *Larotonda v. Commissioner,*[44] the Tax Court held that the involuntary withdrawal from a Keogh account to satisfy a federal tax lien was not subject to the I.R.C. section 72(m)(5) penalty for premature withdrawal. However, the Office of Chief Counsel has announced nonacquiescence to this decision with no appeal. The IRS cited *In re Kochell,*[45] which involved an IRA distribution in bankruptcy where the court held that the statute makes no exceptions from the penalty except in cases of disability. The IRS stated that the individual benefited "to

[41] No. 92-77 (Bankr. W.D. Ark. Sept. 10, 1992).
[42] Adv. No. 92-913 (Bankr. M.D. Fla. 1993).
[43] *In re Sills*, 82 F.3d 111 (5th Cir. 1996).
[44] 89 T.C. 287 (1987).
[45] 804 F.2d 84 (7th Cir. 1986).

the same extent as if he had withdrawn the money himself in order to pay off creditors."

The bankruptcy court held, in *William Thomas Hanna v. United States*,[46] that the IRS may not levy postpetition against the proceeds of a noncompetition personal service contract. The court noted that the value of the contract, at the time of the filing, was dependent on the continued personal service—that is, to not compete—of Hanna.

In a case of a secured lien, the Ninth Circuit BAP held that there is no requirement that the IRS file a proof of claim to protect a secured tax lien.[47]

For additional discussion of the proof of claims and the importance of filing, see § 10.3(b).

In *In re Schreiber*,[48] the bankruptcy court held that tax liens attach to subsequent equity when there was no equity at the time the petition was filed. Citing *Dewsnup v. Timm*,[49] the bankruptcy court noted that "[a]ny increase over the judicially determined valuation during the bankruptcy rightly accrues to the benefit of the creditor, not to the benefit of the debtor."

The court then ruled that, because the IRS was oversecured, it is entitled to postpetition interest from the date the petition was filed until the date the secured claim is fully paid.

A bankruptcy court held that an IRS tax lien attached to a debtor's interest in an ERISA-qualified pension plan, even though Massachusetts state law exempts the pension plan from creditors' claims.[50] Citing *United States v. Bess*,[51] the court stated that state law "is powerless to exempt property from the federal tax lien." Thus, as security for its claim, the IRS has a valid lien on a taxpayer's pension plan.

U.S. district court[52] has determined that a debtor's annuity rights are property of his bankruptcy estate, reversing the order of a bankruptcy court that sustained the debtor's objection to a proof of claim.

After the taxpayer, James McIver Jr., filed a chapter 13 bankruptcy petition, the IRS filed a proof of claim for $119,700, alleging that it held a secured claim for unpaid federal income taxes as to McIver's car, real estate, and all of his right, title, and interest to property under section 6321. At the time of the bankruptcy filing, McIver had a beneficial interest in six pension annuity contracts administered by Teachers Insurance and Annuity Association/College Retirement Equities Fund (the pensions), from which he was receiving $2,273 in monthly income.

On appeal, the district court determined that McIver's rights in the pensions were property of the bankruptcy estate and, therefore, the IRS had a secured claim against McIver's annuity rights to the extent of their value. The district court noted that the parties agreed that the pensions qualified as spendthrift

[46] 1992 Bankr. LEXIS 1610 (Bankr. W.D. La. 1992).
[47] *In re Bisch*, 159 B.R. 546 (Bankr. 9th Cir. 1993).
[48] 163 B.R. 327 (Bankr. N.D. Ill. 1994).
[49] 112 S. Ct. 773 (1992).
[50] *In re Tourville*, 216 B.R. 457 (Bankr. D. Mass. Nov. 19, 1997).
[51] 357 U.S. 51 (1958).
[52] *In re McIver*, 255 B. R. 281 (D. Md 2000).

trusts under New York law, which many courts have excluded from the bankruptcy estate under 11 U.S.C. section 541(c)(2). The district court relied upon *In re Lyons*,[53] and reasoned that a debtor's beneficial interest in a trust is property of the estate to the extent that, under federal tax lien law, the IRS could reach the interest outside of bankruptcy, even if the interest would be excluded from the bankruptcy estate under section 541(c)(2) with respect to other creditors due to valid spendthrift provisions. The value of the annuity rights were fixed at the present value of the future stream of payments to be received by Debtor under the annuities.[54]

A bankruptcy court held that a federal tax lien attached to a debtor's interest in property owned with his nondebtor spouse as tenants-by-the-entireties, and, thus, the IRS can sell the property to satisfy the debtor's outstanding tax liability.[55] The property was included in the debtor's bankruptcy estate, and under Oregon state law, the tax lien attached to the property and creditors of one spouse can have a lien that attaches to that spouse's interest in land held by the entireties.

The bankruptcy court concluded in *In re Young*[56] that because Young was entitled to the refund at the time he filed his bankruptcy petition, the refund was part of the estate to which the IRS's tax lien attached. Rodney Young objected to the proofs of claim filed in his bankruptcy case by the IRS. After Young had filed for bankruptcy, the IRS released his 1993 refund of $3,293, and filed a claim in the bankruptcy case for $11,819, of which $6,113 was a secured claim. The bankruptcy court agreed with the IRS that despite having released the refund, it still held a security interest in Young's property.

I.R.C. section 6334(a)'s limitation on the government's power to seize property is not a prohibition on the IRS's ability to secure its interest in property.[57] The IRS obtained a secured tax claim in a house that the taxpayers had purchased with workers' compensation benefits, a claim that was challenged by the taxpayers. The Fifth Circuit affirmed the decisions of the bankruptcy and district courts by holding that the levy exemption for workers' compensation did not limit the reach of a tax lien under I.R.C. section 6321.

A chapter 7 debtor was not allowed to avoid a prepetition levy that perfected a tax lien.[58] The IRS levied on a bank account of the taxpayer two days before he filed a chapter 7 petition, and three weeks later the bank disbursed the balance of the account to the IRS. The taxpayer objected on the basis that the funds represented prepetition wages and that, under state (Colorado) law, 75 percent of his wages were exempt from the bankruptcy estate and the claims of his creditors. He sought turnover of 75 percent of the amount disbursed by the bank.

[53] 148 B.R. 88 (Bankr. D.D.C. 1992).
[54] *See In re Wesche*, 193 B.R. 76, 78-79 (Bankr. M.D. Fla. 1996) and cases cited therein.
[55] *In re Pletz*, 225 B.R. 206 (Bankr. D. Or. 1997), *aff'd* 234 B.R. 800 (D. Or. 1998).
[56] 1994 Bankr. LEXIS 2116; 75 AFTR 2d (PH) 728 (Bankr. S.D. Ga. 1994).
[57] *In re Sills*, 82 F.3d 111 (5th Cir. 1996).
[58] *In re Davis*, 1996 Bankr. LEXIS 133 (Bankr. D. Colo. 1996).

The court ruled that only the trustee in a chapter 7 proceeding has standing to request turnover but that the taxpayer had standing to bring an action to avoid a preferential transfer to preserve an exemption. On the merits, however, the court concluded that the IRS's prepetition levy perfected its security interest in any wages on deposit and, because the IRS had a perfected prepetition lien, the funds were not subject to avoidance.

(c) State and Local Tax Liens

The bankruptcy court has ruled that a lien on "homestead property," which was perfected by the IRS prior to the filing of a petition for relief under chapter 7 by the taxpayer, remains valid even though the tax obligation itself must be discharged under the Bankruptcy Code. A discharge in bankruptcy does not prevent the enforcement of valid liens on nonexempt property as well as exempt property.[59]

State and local tax liens can also be used to secure the payment of taxes (such as income, sales, and real or personal property taxes) owed to a state or local government. The assessment of these taxes and the filing of liens depend on state law. For example, in some cases, the tax lien may arise automatically, but in others the tax authority must take some type of action such as issuing a warrant before the tax lien will be effective. State law determines the effective date of the lien and the property to which the lien attaches. Some states may have liens that attach to all property; however, in the case of real property taxes, the lien generally only attaches to the property subject to the tax.

(d) Priorities Outside Bankruptcy

As noted above, a tax lien becomes effective without filing the notice; however, the filing of a notice determines the priority of the tax against other claimants, according to I.R.C. section 6323. In the case of a properly filed notice, the "first-in-time, first-in-right" rule applies. Thus, if the tax lien notice is filed prior to filing of the financial statements, the tax lien will have the senior status. A purchase money security interest for both personal and real property acquired after a tax lien was filed has priority over a perfected federal tax lien.

I.R.C. section 6323(c) allows certain commercial transaction financing agreements a preferred status over tax liens. To qualify, the property must be negotiable instruments, accounts receivable, mortgages on real property, or inventory. The financing agreement must precede the filing of the tax lien, and any property acquired after the lien is filed must be acquired within 45 days after the tax lien is perfected. I.R.C. section 6323(d) also has another 45-day rule. Under this rule, the tax may be subordinated. A filed tax lien is not valid with respect to a security interest that came into existence within 45 days after the filing of the tax lien as the result of a disbursement or an advance made according to the terms of a written agreement entered into prior to the filing of the tax lien.

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[59] *In re Stephenson*, *Adv.* No. 87-0471-BKC-AJC; LEXIS, 88 TNT 208-C (Bankr. S.D. Fla. Sept. 20, 1988).

Unsecured creditors who have not reduced their claim to judgments will have their claims subordinated to tax liens even though notice was not filed. On the other hand, claims reduced to judgments, mechanics' liens, and secured creditors' claims have a priority over unfiled tax liens.

In *United States v. 717.42 Acres of Land,*[60] the Fifth Circuit held that expenses of a liquidator have priority over a tax lien.

Petit Bois, Inc. (PBI) owned land on Petit Bois Island off the Mississippi coast and transferred an undivided three-fourths interest (two-thirds of this interest was later transferred to others) in the mineral estate to its shareholders in 1954. John Stocks purchased all of PBI's shares in 1979. In 1980, the United States filed a declaration of taking for 717.42 acres of land on the island, which included the acreage on which PBI held its one-fourth mineral interest. As a result of this action, PBI then terminated its activity on the island, and Stocks placed PBI in voluntary liquidation and was designated the corporate liquidator. PBI conveyed all of its rights in the mineral estate to Coastal Land & Marine Company, Ltd., a partnership owned by Stocks. In 1984 and 1985, the IRS made personal tax assessments against Stocks and filed tax liens from 1986 through 1988. Stocks filed for bankruptcy in December 1988.

The United States valued the one-fourth mineral interest at zero dollars, but the district court overseeing the eminent domain proceedings awarded compensation of almost $1.1 million and ordered the government to place $2.8 million (including interest) into the court registry. The court then awarded more than $1.7 million in fees and costs to PBI's attorneys, and ordered any residue to be distributed to Coastal as assignee of PBI's assets, subject to a final determination by the bankruptcy court presiding over Stock's petition.

The Fifth Circuit held that, under applicable state law, the liquidator is vested with all rights, powers, and duties of the board of directors and officers, and that the liquidator owes a fiduciary duty to the corporate creditors. The court noted that the liquidator is required to pay the debts of the dissolved corporation, including attorneys' fees and costs. The court concluded that any rights Stocks had in the eminent domain proceedings were subject to the priority claims of the attorneys.

The Fifth Circuit also held that the United States had no right of setoff—the claim for compensation was owed to PBI by the United States and the tax liabilities were owed by Stocks.

Finally, the Fifth Circuit concluded that the attorneys had super priority under I.R.C. section 6323(b)(8) and that the exceptions of section 6323(b)(8) only apply where there is right of setoff.

(e) Priorities in Bankruptcy

Section 506 of the Bankruptcy Code provides that secured claims are to be paid to the extent of the value of the collateral. If the amount of the claim is greater than the value of the collateral, the difference is considered an unsecured claim.

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[60] 955 F.2d 376 (5th Cir. 1992).

Section 506 treats secured claims, judgments, and statutory liens, including tax liens, the same way. Thus, the rule of "first-in-time, first-in-right" applies.

The doctrine of "first-in-time, first-in-right"[61] was applied to tax liens by the Sixth Circuit. In *In re John Darnell*,[62] where the federal tax lien was perfected prior to the Kentucky Department of Revenue's lien, the court held that the federal tax lien was superior to the state of Kentucky's tax lien and awarded to the U.S. the remaining property of the debtor.

The district court, in *United States v. Johnny Wayne Clayton*,[63] held that the IRS could not satisfy its lien against Johnny Wayne Clayton from the funds owed to his spouse from the sale of property declared as exempt by his spouse in their joint petition. The court noted that the IRS had an opportunity to file an objection to the wife's equitable interest in the exempt homestead property, but failed to file such an objection. The failure of the IRS to timely file its objection to the amendment to the exemption schedule adding sale proceeds, and the IRS's confusion regarding the spouse's equitable interest in the exempt property, were noted by the court in discussing the case.

An IRS tax lien does have priority over judgment creditors. In *In re Richard Granger*,[64] the court was asked to determine whether a tax lien had priority over a default judgment and a garnishment against the Grangers' 1/12th interest in Gertrude Granger's estate. The court, holding that the tax lien has priority, stated that the IRS's lien attaches to all property of the debtor, which included the interest in Granger's estate. Under the proposition of "first-in-time, first-in-right" (*United States v. City of New Britain*[65]), the IRS would have priority because it filed before the creditor garnished the estate.

In *In re National Financial Alternatives, Inc.*,[66] the court examined the relationship between a bank's lien and the lien of the IRS. National Financial Alternatives, Inc. (NFA) produces steel products. In the course of business, NFA receives purchase orders, buys raw material, ships the finished product, and generates accounts receivable and collects them. NFA's claim against First Midwest Bank/Joliet is partially secured by a perfected security interest both in the inventory, accounts receivable, and purchase orders of NFA, and in the proceeds of these items of collateral.

A district court affirmed a bankruptcy court decision prohibiting the IRS from participating in the distribution of estate assets because the IRS failed to file a motion to value collateral under Bankruptcy Rule 3012.[67] The bankruptcy court ruled this way even though the tax lien was allowed as a secured claim.

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[61] *See Pearlstein v. U.S. Small Business Administration*, 719 F.2d 1169 (D.C. Cir. 1983).
[62] 834 F.2d 1263 (6th Cir. 1987).
[63] No. CV 487-026; LEXIS, 87 TNT 193-28 (S.D. Ga. 1987).
[64] 90 B.R. 298 (Bankr. N.D. Ohio 1988). *See In re Burwick*, 186 B.R. 501 (Bankr. W.D. Wash. 1995).
[65] 347 U.S. 81 (1954).
[66] 96 B.R. 844 (Bankr. N.D. Ill. 1989).
[67] *In re Envirocon Int'l Corp.*, 214 B.R. 251 (M.D. Fla. 1997), *reaff'd*, 992 F. Supp. 978 (M.D. Fla.1998).

The district court held that the lower court properly precluded the government from participating in the distribution of estate assets, citing *In re Linkous*[68] and *In re Harrison*.[69] The court found the government's discussion of the scope of a federal tax lien largely irrelevant, because tax liens are treated the same as conventional secured claims under the Bankruptcy Code. The court further noted that there is nothing in bankruptcy law that affords the government more protection than other secured creditors. The IRS's size and complexity do not excuse it from complying with the Bankruptcy Code; instead, because the IRS is a huge federal governmental agency, its level of sophistication as a secured party should actually be higher than that of the ordinary private secured party.

NFA failed to properly remit its withholding taxes and on April 16, 1988, the IRS filed a notice of tax lien for the 1987 withholding taxes. NFA filed a bankruptcy petition on June 22, 1988. On the schedules filed with the bankruptcy court, the assets of NFA were less than the indebtedness to First Midwest. Both the bank and the IRS filed motions to keep NFA from using cash collateral. When NFA filed its bankruptcy petition, there was a fairly large balance in the inventory and accounts receivable accounts, but almost no cash balance.

The IRS argued that its tax lien had priority over the bank's security interest in the accounts receivable acquired by NFA more than 45 days after filing of the tax lien. The inventory, contract rights, and accounts receivable acquired by NFA before the expiration of the 45-day period were "qualified property," according to the IRS, under I.R.C. section 6323(c).

First Midwest argued that its security interest had priority in the accounts receivable acquired after the expiration of the 45-day period to the extent such accounts receivable are proceeds of "qualified property." The IRS claimed that accounts receivable cannot be considered "proceeds" of any form of collateral because, under a Treasury Regulation,[70] accounts receivable may only be acquired at the time the right to payment is earned.

The bankruptcy court held that accounts receivable may be proceeds of both inventory and contract rights and that the bank has a qualifying security interest in any accounts receivable that were held by NFA on June 22 and that were either acquired before the expiration of the 45-day period or were the proceeds of contract rights or inventory acquired before that date. The court further ruled that the bank has the burden to prove which of the accounts receivable fit into these categories.

The court also noted that if some of NFA's inventory at June 22—the time of filing the bankruptcy petition—was purchased with cash received between the expiration of the 45-day period and June 22, it may not be qualified property.[71] Under this condition, the IRS is entitled to claim an interest before that of the bank. However, the IRS has the burden of establishing the value of these rights.

The court did not accept the argument of the IRS that accounts receivable may not be proceeds; the Treasury Regulations plainly extend the protection for

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[68] 141 B.R. 890 (Bankr. W.D. Va. 1992), *aff'd* 990 F. 2d 160 (4th Cir. 1993).

[69] 987 F.2d 677 (10th Cir. 1993).

[70] Treas. Reg. 301.6323(c).

[71] *Id.*

security interests in qualified property to the proceeds of that property. Those proceeds are normally in the form of cash, negotiable instruments, or accounts receivable.

The court held that NFA is required to obtain consent of both the bank and the IRS before using any cash that it acquires.

In *Oliver J. Latour, Jr. v. Commissioner*,[72] the bankruptcy court held that tax liens do not attach to property acquired after the petition is filed. Oliver and Jane Latour filed federal income tax returns for the years 1980 and 1985 through 1987. The IRS assessed deficiencies against the Latours for those years and filed notices of federal tax liens against the Latours' property. In September 1991, the Latours filed for bankruptcy under chapter 7 and listed the tax liabilities in their schedules filed with the court. They filed an adversary proceeding to determine the dischargeability of the tax liabilities and the validity of the tax liens. The bankruptcy court held that the tax liabilities were dischargeable because the tax claims were not subject to the exception to discharge set forth in section 523 of the Bankruptcy Code and because the tax returns were filed more than 2 years before the date of the petition. The court also determined that the tax liens that attached to prepetition property and to any other property of the estate were valid and enforceable. However, the court ruled that the liens did not attach to any property acquired after the petition was filed and, thus, could not be enforced against such property.

An issue that has received considerable attention in the Ninth Circuit is the priority of a federal tax lien over liens created by state law. The Ninth Circuit examined this issue extensively in *In re Kimura*.[73]

During part of 1986 and 1987, Roger Kimura and Donna Kimura, as "responsible persons" of Nikko Garden, Inc., failed to pay over to the U.S. income and federal FICA taxes due. On May 19, 1987, the IRS assessed a penalty against the Kimuras in the amount of $103,617 for the taxes owed, under I.R.C. section 6672. As a result of the assessed and unpaid federal taxes, a federal tax lien attached to all of the Kimuras' property pursuant to I.R.C. section 6321, and proper notice of the federal tax lien was filed on June 3, 1987.

In 1988, the Kimuras filed a chapter 7 bankruptcy petition and the bankruptcy trustee attempted to liquidate the Kimuras' liquor license issued by the Alaska Alcoholic Beverage Control Board (ABC Board). Subsequently, the bankruptcy court approved the sale of the Kimuras' interest in the liquor license for $82,500. Alaska law provides that a liquor license may not be transferred to another person without the consent of the ABC Board.[74] The statute also provides that the ABC Board may not consent to the transfer of a liquor license if the transferor has not paid all debts or taxes arising from the conduct of the business licensed under this title unless the transferor gives, for the payment of the debts or taxes, security that is satisfactory to the creditor or taxing authority.[75] Three of the Kimuras' trade creditors initially objected to the proposed sale but later

[72] Adv. No. 91-0350 (Bankr. S.D. Ala. Mar. 27, 1992).
[73] 969 F.2d 806 (9th Cir. 1992).
[74] Alaska Stat. section 04.11.040.
[75] *Id.*, section 360(4).

agreed to the sale, provided the claims of all creditors who under state law may object to the approval of the sale, transfer, and renewal of the license could be asserted against the cash proceeds of the sale. The amended order also provided that all liens and encumbrances on the liquor license would be transferred to the proceeds of the sale.

The trustee filed a notice of final accounting in which he proposed to distribute the funds in the following order:

- Administrative expenses, including a broker's commission, incurred in the sale of the license.
- $15,528.87 to the Municipality of Anchorage for local taxes.
- The balance of the proceeds on a pro rata basis to creditors who had liens against the liquor license recognized by the ABC Board.

The IRS objected to this proposed distribution, arguing that it was entitled to receive the entire balance after the payment of taxes to the Municipality of Anchorage. The bankruptcy court overruled the objection and the Ninth Circuit BAP affirmed the bankruptcy court.

The Ninth Circuit held that whether the interest created by the state is "property" or a "right to property" to which the federal tax lien can attach is a matter of federal law.[76] The Ninth Circuit noted that, were federal law not determinative of the classifier of the state-created interest, states could defeat the federal tax lien by declaring an interest not to be property, even though the beneficial incidents of property belie its classification.[77]

The Ninth Circuit noted that the nature of the interest created by Alaska does not require extensive analysis because a liquor license will constitute property, within the meaning of federal law, if the license has beneficial value for its holder and is sufficiently transferable. The court cited *Little v. United States,*[78] which concluded that a declaration that an asset is property under I.R.C. section 6321 involves determining whether it has pecuniary worth and is transferable.[79]

The *Kimura* court stated that courts have recognized the value that a liquor license creates for a licensee. Generally, a liquor license has intrinsic worth that is subject to bargain and sale in the marketplace. The court further noted that, subject to certain conditions, Alaska liquor licenses are transferable both from person to person and from location to location.[80] The transferor of a license may

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[76] *See National Bank of Commerce*, 472 U.S. 713, 727 (1985); *In re Terwilliger's Catering, Inc.*, 911 F.2d 1168, 1171 (6th Cir. 1990), *cert. denied,* 501 U.S. 1212 (1991) (holding that federal law determines whether state-created interests constitute property to which the federal tax lien can attach); *21 West Lancaster Corp. v. Main Line Restaurant, Inc.*, 790 F.2d 354, 356 (3rd Cir. 1986) (same); *Rodriquez v. Escambron Dev. Corp.*, 740 F.2d 92, 97 (1st Cir. 1984) (same).

[77] *Terwilliger's Catering*, 911 F.2d 1168, at 1171-72 (citing Note, "Property Subject to the Federal Tax Lien," 77 *Harv. L. Rev.* 1485, 1487 (1964)); *see* Bess, 357 U.S. 51, 56-57 (1958); *21 West Lancaster Corp. v. Main Line Restaurant, Inc.*, *supra* note 36.4, at 357-58.

[78] 704 F.2d 1100, 1105-06.

[79] *See also In re Terwilliger's Catering*, 911 F.2d 1168, at 1171; 21 *West Lancaster Corp. v. Main Line Restaurant, Inc.*, *supra* note 36.4 at 357.

[80] Alaska Stat. sections 04.11.040, 04.11.280, and 04.11.290.

retain a security interest in the license to secure payment for real and personal property conveyed to the transferee.[81] Based on these statutes, the Kimuras' liquor license was ultimately capable of being surrendered and reduced to a value of $82,500. Thus, the Ninth Circuit concluded that an Alaska liquor license satisfies both requirements—independent value and sufficient transferability—and constitutes property or a right to property within the meaning of I.R.C. section 6321. As a result, a federal tax lien attached to the Kimuras' liquor license when notice of the tax lien was filed by the IRS.

However, the trade creditors argued that even if the Kimuras' liquor license was property to which the federal tax lien attached, all the IRS obtained was the debtors' right to petition the ABC Board for transfer of the liquor license, and because Alaska law mandates payment to trade creditors before transfer of the license can occur, the IRS was entitled to attach only the residual value of the license after payment to the debtors' trade creditors. In support of their contentions, the trade creditors cited a string of Ninth Circuit authority, beginning with *United States v. California*.[82]

In a footnote, the Ninth Circuit stated:

> BAP came to this conclusion when it improperly relied on state law. The Supreme Court in *Bess* made clear, however, that federal law is to be used to determine the consequences of the attachment of a federal lien to property held by the debtor. 357 U.S. at 55; see also A*quiline v. United States,* 363 U.S. 509, 513-14, 4 L. Ed. 2d 1365, 80 S. Ct. 1277, 5 A.F.T.R.2d (P-H) 1698 (1960) ("Once the [federal] tax lien has attached to the taxpayer's state-created interests, we enter the province of federal law, which we have consistently held determines the priority of competing liens asserted against the taxpayer's 'property' or 'rights to property'"); *United States v. Acri,* 348 U.S. 211, 213, 99 L. Ed. 264, 75 S. Ct. 239, 46 A.F.T.R. (P-H) 986 (1955) ("The relative priority of the lien of the United States for unpaid taxes is . . . always a federal question to be determined finally by the federal courts. The state's characterization of its liens, while good for all state purposes, does not necessarily bind this Court."). Citing *Queen of the North,* 582 P.2d at 149, the panel used Alaska law to conclude that the federal tax lien attached only to the debtors' right to petition the ABC Board for transfer of the liquor license.

The Ninth Circuit rejected the trade creditors' argument that the state of Alaska may validly impose on transferability conditions that reserve an interest not in itself, but in favor of a class of trade creditors.[83] The Ninth Circuit agreed with the IRS that, in this case, "state law has been used to create in a creditor other than the State, a property interest that would limit the property subject to a federal tax lien."

The Ninth Circuit concluded that Alaska's statutory conditions for the transferability of a liquor license invalidly establish in trade creditors a property interest that violates the supremacy of a federal tax lien under federal law.

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[81] *Id.,* section 04.11.270.

[82] 281 F.2d 726 (9th Cir. 1960).

[83] *See In re Leslie*, 520 F.2d 761, 763 (9th Cir. 1975) ("While a state, as the creator of a liquor license, may validly impose conditions on its transferability for the state's own benefit, it may not, consistently with paramount federal law, impose conditions which discriminate in favor of particular classes of creditors").

The Ninth Circuit expanded on the difference between its decision in *United States v. California,* where it held that California had a right to reserve to itself payment of state taxes as a statutory condition for the transfer of a state-created liquor license,[84] and the facts in *Kimura.* The court concluded:

> [T]he state's statutory scheme was not in violation of the "paramount right of the United States to levy and collect taxes pursuant to Article I, section 8, of the United States Constitution," even though the scheme's effect was to subordinate the federal tax lien. *Id.* at 727. We reasoned that the issue was not the supremacy of the federal tax lien but the nature of the property to which the lien attached.

The Ninth Circuit, in *United States v. California,* noted:

> [The] license existed because the state had issued it and if the licensee acquired something of value, it was because the state had bestowed it upon him. Whatever value the license, as property, may have had to a purchaser depended upon its transferability. If it was transferable, it was because the state had made it so. If the state had seen fit to impose conditions upon issuance or upon transfer of property it has wholly created, that is the state's prerogative so long as its demands are not arbitrary or discriminatory.[85]

The Ninth Circuit, in *Kimura,* then noted that, because California had required that state taxes be paid before transfer of the liquor license, the interest in property to which the federal lien attached was the residual value of the property after the state taxes were paid. Consistent with its holding in *United States v. California,* the Ninth Circuit concluded that the state of Alaska had the right to reserve to itself payment of delinquent state and local taxes, such as taxes owed to the Municipality of Anchorage, which are entitled to first priority from the proceeds of the sale of the Kimuras' liquor license.[86]

The Ninth Circuit noted that two cases[87] have given priority to tax claims but that these cases did not involve a federal tax lien or a preference for third-party creditors.[88] The Ninth Circuit noted that these cases cannot "be read for the broader proposition that the state can reserve any interest it sees fit, to the detriment of the federal government."[89]

The *Kimura* court noted that, in *Artus v. Alaska Department of Labor (In re Anchorage International Inn, Inc.),*[90] the Ninth Circuit considered whether

[84] 281 F.2d 726 at 728.

[85] *Id.*

[86] *In re Kimura*, *supra* note 36.1, at 812, referring to *Board of Trade v. Johnson*, 264 U.S. (1924) and *Hyde v. Woods*, 94 U.S. 523 (1876) (holding that because stock exchanges created property interest in seats on exchanges, they could reserve unto themselves the right to be paid first any debts owed them from proceeds received upon sale of seats).

[87] *In re Farmers Markets, Inc.*, 792 F.2d 1400, 1403 (9th Cir. 1986) (holding California entitled to payment of taxes before transfer of a liquor license); *In re Professional Bar*, 537 F.2d 339, 340 (9th Cir. 1976) (holding California entitled to payment of taxes ahead of wage claimants).

[88] *See In re Professional Bar*, 537 F.2d 339, at 340 n.2 ("Limitation of the value of state-created property on behalf of the state itself (and not private creditors) does not interfere with or frustrate federal bankruptcy law").

[89] *In re Kimura*, 969 F.2d 806 at 812-13.

[90] 718 F.2d 1446, 1447 (9th Cir. 1983).

Alaska's statutory requirement that trade creditors be paid before transfer of a liquor license was preempted by federal bankruptcy law and held that "no statutory bankruptcy policy forbids [Alaska] from giving one creditor a greater right to payment of his claim from a given asset than that conferred to another."[91] This case, however, did not construe federal law involving competing claims as against a federal tax lien.[92]

The Ninth Circuit concluded that Alaska may reserve a property interest to itself, to be paid before transfer of a liquor license, but it may not reserve the same property interest in third parties and thereby subordinate the federal tax lien.[93]

After ruling that the federal tax lien in this case attached to the proceeds from the transfer of the Kimuras' liquor license, the Ninth Circuit concluded that, under federal law, when a federal tax lien and a state law lien compete, priority is determined by the general rule that "the first in time is the first in right."[94]

The Sixth Circuit[95] gives a federal tax lien priority over a state law lien. The bankruptcy court held that under Kentucky law, Dishman Independent Oil, Inc.'s attachment lien became effective at the time of the levy, rather than at the time of the judgment, giving it priority over the federal tax lien. The district court affirmed the bankruptcy court's decision. The Sixth Circuit reversed by explaining that the Supreme Court determined in *United States v. McDermott*[96] that a state lien is perfected only when the identity of the lien, or the property subject to the lien, and the amount of the lien are established. The appeals court here concurred with the IRS's assertion that Dishman's lien was not perfected until April 27, 1992, when the bankruptcy court determined the amount of the lien and the property subject to it.

Citing *United States v. Acri,*[97] the appeals court held that, for federal tax purposes, Dishman's interest in the property was inchoate when the government's tax lien attached, because the amount of Dishman's lien was contingent on the bankruptcy court's decision. An interesting aspect of this case is that it appears that the IRS may have become the owner of the property at issue even before filing its tax lien. As a result the Sixth Circuit advised that on remand, the lower court must "also consider whether the actions of the IRS, purporting to file a tax lien on its own property in January 1992, constituted additional inequitable conduct."

In *In re Boerne Hills,*[98] the Fifth Circuit held that a tax lien that is avoidable under state law has priority if no action is taken to avoid the lien. Chrysler Credit Corp. perfected a lien against Boerne Hills Leasing Corp. by filing a financing statement. Subsequently, the City of Boerne (Texas) and Kendall

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[91] *Id.* at 1451.
[92] *In re Kimura* 969 F.2d 806 at 813.
[93] *Id.*
[94] *Id.*, citing *United States v. City of New Britain*, 347 U.S. 81, 85 (1954).
[95] *United States v. Dishman Independent Oil Inc.*, 46 F.3d 523 (6th Cir. 1995).
[96] 113 S. Ct. 1526 (1993).
[97] 348 U.S. 211 (1955).
[98] 15 F.3d 57 (5th Cir. 1994).

County filed tax liens, and Boerne Hills filed a bankruptcy petition. The bankruptcy court authorized the debtor to sell its inventory free and clear of any liens and then determined that Chrysler's lien had priority. Because the proceeds from the sale did not generate sufficient proceeds to cover Chrysler's claim, the bankruptcy court ordered Boerne Hills to distribute all the sale proceeds to Chrysler. The local taxing authorities objected.

At a hearing, the taxing authorities argued that their liens had priority pursuant to Texas law, and Chrysler claimed that because the tax liens were unenforceable against a bona fide purchaser without notice, at the time of the bankruptcy filing, they were unperfected. The bankruptcy court held that Chrysler had a superior claim, and the district court affirmed, holding that the tax liens were avoidable under section 545(2) of the Bankruptcy Code. Although neither the debtor-in-possession nor the trustee had initiated an adversary proceeding to avoid the tax liens, the district court concluded that Chrysler had standing to exercise the debtor-in-possession's avoidance power.

The Fifth Circuit reversed, holding that the tax liens had priority because they were not avoided. The court noted that, under Texas tax law, a tax lien has priority over all other liens. However, the tax liens were avoidable because they were unenforceable against a bona fide purchaser without notice of the tax liens. The Fifth Circuit concluded that only the trustee or debtor-in-possession has avoidance powers under the Bankruptcy Code, and that a creditor may exercise that power only after moving the bankruptcy court for authority to act on behalf of the trustee or debtor-in-possession. Because Chrysler did not request such authorization, the Fifth Circuit concluded that the tax liens were not avoided.

In *C.S. Associates v. Miller*,[99] the bankruptcy court held that the city's prepetition liens had priority over secured claim and suggested that the city attempt to collect its postpetition taxes and rents for water and sewer from the sales proceeds pursuant to either section 503(b)(1)(B)(i) or section 506(c) of the Bankruptcy Code. The city then moved the bankruptcy court, pursuant to section 506(c), to surcharge the sales proceeds and allow the city to collect its postpetition tax claims. The bankruptcy court granted the motion. The secured lender appealed, arguing that the city had not satisfied 11 U.S.C. section 506(c), and the district court affirmed.

The Third Circuit reversed the decision of the lower courts and held that the city did not demonstrate that the taxes on which its claim was based conferred a direct benefit to the secured lender, whose claim was secured by the property. The Third Circuit noted that the city's postpetition real estate taxes and water and sewer rents could not attain lien status for purposes of the Bankruptcy Code according to section 362(a)(4) of the Bankruptcy Code. Citing *Equibank, N.A. v. Wheeling-Pittsburgh Steel Corp.*, 884 F.2d 80 (3d Cir. 1989), the court noted that for taxes to be paid absent lien status, "they may be payable by the secured creditor as payment for benefit received." The appeals court held that the city had not conferred a sufficient, tangible benefit on the creditor in return for the real estate taxes or water or sewer rents, and thus would not be preferred over the secured creditor. The Third Circuit explained that "[h]ad the City put forth evidence that

[99] 29 F.3d 903 (3d Cir. 1994).

the property had received some direct or special government service which benefited the property."

In *Paul Revere Life Insurance Co. v. Brock,*[100] the Sixth Circuit reversed the lower court and held that interest has the same priority as a tax lien, noting that pursuant to I.R.C. section 6321, tax liens included all interest due. According to I.R.C. section 6601(a), the interest on underpaid taxes accrues from the date payment is due until the date paid and under section 6665(a), penalties and interest are to be collected in the same manner as taxes. The court stated that "[f]rom these statutes, it follows that whatever priority the government enjoys with regard to tax liens, the government enjoys the same priority with regard to interest in those liens."

A federal tax lien on the sales proceeds of the debtor corporation's property had priority over the opposing creditor because the creditor was merely the debtor's alter ego.[101] The Eighth Circuit concluded that the owner of the debtor corporation attempted to shelter the debtor's assets from its creditors by means of a self-imposed lien and that it would be inequitable to allow the debtor to deplete the estate by paying itself at the expense of its true creditors.

A district court held that the IRS had priority over a judgment creditor to the proceeds of a noncompete agreement, finding that the bankrupt couple who acquired the proceeds resided in Florida where the IRS filed its lien and had only business ties with Illinois.[102]

The bankruptcy court[103] held that a tax lien for unpaid withholding taxes attached to the taxpayer's rights the settlement monies received as soon as the case was settled, and the settlement monies were paid to her counsel. The settlement funds that were disbursed to creditors after being received and prior to the filing of the bankruptcy petition and recovered by the trustee were subject to the tax lien. However, the court held that the IRS's lien is subordinate to the trustee's commissions and the fee of the attorney for the trustee.

(f) Chapter 7

Section 724(a) of the Bankruptcy Code gives to the trustee the right to avoid liens that are for fines, penalties, forfeiture, and so on, that arose prior to the filing of the petition, and that are not for actual pecuniary losses. Section 544(a) of the Bankruptcy Code allows the trustee to cancel any tax lien that was not filed prior to the bankruptcy petition.

In *United States v. LMS Holding Co.,*[104] property subject to the tax lien was acquired by Retail Marketing Corp. (RMC) under the creditors' bankruptcy plan of liquidation. The IRS was notified of the bankruptcy and was aware of the formulation and confirmation of the plan that included the terms of the sale to RMC. The IRS did not file a new notice of tax lien naming RMC, and RMC

[100] 28 F.3d 551 (6th Cir. 1994).
[101] *In re B.J. McAdams, Inc.*, 66 F.3d 931 (8th Cir. 1995).
[102] *In re Carousel Int'l Corp.*, 219 B.R. 807 (C.D. Ill. 1997).
[103] *In re Johnetta Wadkins*, 2000 Bankr LEXIS 475 (Bankr. E.D. Ky. 2000).
[104] 161 B.R. 1020 (N.D. Okla. 1993).

subsequently filed for bankruptcy. The IRS filed its proofs of claim against RMC approximately one year after the deadline.

The bankruptcy court held that because the IRS failed to timely file a new notice of tax lien against RMC, RMC was entitled to avoid the lien. The IRS's lien was therefore unsecured.

On appeal, the district court affirmed the lower court's decision relegating the IRS claim to that of an unsecured creditor. The court noted that, although no mandatory precedent could be found on the issue, the facts in the case were analogous to cases involving taxpayer name changes, where courts have held that the IRS has an affirmative duty to refile the notice of tax lien to show the taxpayer's new name.

The court explained that the transaction in this case was more complex than a name change, and if the IRS is required to file a new notice when a taxpayer merely changes names, the same result should ensue when an entirely different entity is involved.

Collateral that is subject to a tax lien may be sold in bankruptcy. Section 724(b) of the Bankruptcy Code provides that, in a chapter 7 liquidation, tax claims secured by a lien are paid only after the first six priority items are paid. Listed below is the order in which the proceeds from the sale of property that is subject to a tax lien are to be distributed:

1. Secured lienholders superior to tax lien;
2. First six priorities of section 507 of the Bankruptcy Code, to the extent of the amount of the tax lien;
3. Tax claims secured by tax liens, to the extent that tax claims exceed the amount paid in section 507 priorities;
4. Lienholders with claims junior to tax liens;
5. Tax claims not previously satisfied;
6. Balance to the estate.

In *N. Slope Borough v. Barstow (In re Bankr. Estate of Markair, Inc.),*[105] the Ninth Circuit analyzed extensively the priority set forth in section 724(a) and accepted the bankruptcy court's interpretation of the distribution and rejected the posi-

[105] 308 F.3d 1057 (9th Cir. 2002). *See also In re Atlas Commercial Floors, Inc.*, 125 B.R. 185, 187 (Bankr. E.D. Mich. 1991) (the statute on its face requires that tax-lien claimants be paid under § 724(b)(5) even when priority unsecured claimants have not been paid in full); *In re A.G. Van Metre, Jr., Inc.*, 155 B.R. 118, 123 (Bankr. E.D. Va. 1993) (holding that priority unsecured claimants are entitled to payment "only to the extent of the amount of the tax liens. Then if [such] claims happen to equal or exceed the amount of statutory tax liens, the statutory tax liens are paid behind the claims of junior consensual lienholders."); *Hargrave v. Township of Pemberton (In re Tabone)*, 175 B.R. 855, 860, 862 (Bankr. D.N.J. 1994) (setting forth a distribution in which the tax-lien claimant received payment under § 724(b)(5) even though priority unsecured claims remained unpaid); *Marc Stuart Goldberg, P.C. v. City of New York (In re Navis Realty, Inc.*), 193 B.R. 998, 1004 (Bankr. E.D.N.Y. 1996). ("It is important to note that the aggregate amount of the payments to the holders of the priority claims under 11 U.S.C. § 724(b)(2) cannot exceed the amount of the tax lien.")

tion taken by the district court. The Ninth Circuit concluded that section 724(b) of the Bankruptcy Code subordinates the interests of tax lienholders to that of priority unsecured creditors, but only up to the total amount of the tax lien. Any remaining proceeds are to be distributed first to junior lien claimants, next to the tax lienholders and, finally, to the debtor's estate. The Court noted that section 724(b)(2) allows the priority claimants under section 507(a) to prime a tax lienholder, but expressly limits the amount distributable to section 507(a) claimants to the "amount of such allowed tax claim that is secured by such tax lien." The amount going to the debtor's estate would then be distributed in accordance with the provisions of section 726 of the Bankruptcy Code.

Thus, in chapter 7, claims of unsecured creditors or claims of secured creditors that are not perfected are subordinated to all tax liens. Note that both personal and real tax liens are subordinated to the payment of priority tax claims. Under the Bankruptcy Act, only personal tax liens were subordinated. These provisions apply equally to federal and state and local taxes. The fact that state and local taxes are subordinated by a federal statute does not violate the Tenth Amendment to the U.S. Constitution, because equal treatment is established for both federal and state and local taxes.[106]

Even unfiled tax liens and unsecured tax claims have priority over other unsecured claims, provided these taxes are classified as priority taxes. Tax claims of individuals that are classified as priority tax claims and are not satisfied are not discharged under the provisions of section 523 of the Bankruptcy Code.

Section 724(d) of the Bankruptcy Code provides that a statutory lien that is determined in the same manner as a tax under I.R.C. section 6323 will be treated under section 724(b) as a tax lien.

(g) Chapter 11

In chapter 11, all tax liens that were properly perfected are treated as secured claims, and their interest must be dealt with in the plan, along with other secured claims. IRS penalties that are fully secured may not be subordinated in chapter 11 as provided for in chapter 7.[107] Unfiled tax liens or tax liens filed after the chapter 11 petition is filed can be avoided.

The payment of both secured and unsecured tax claims must be provided for in the plan. A plan will not be confirmed by the court unless the tax claims are not impaired under the plan, the tax authority accepts the plan, or the plan provides for tax payments in accordance with the provisions of section 507 of the Bankruptcy Code (see §§ 11.2(e) and (m)).

If the tax lien is properly perfected and the tax authority does not accept the plan, then the taxing authority may retain the lien securing the claim, receive deferred cash payments equal to the amount of the claim, or receive the indubitable equivalent of the claim.

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[106] *In the matter of Hirsch-Franklin Enterprises*, 63 B.R. 864 (Bankr. M.D. Ga. 1986); *see In re Kamstra*, 51 B.R. 826 (Bankr. W.D. Mich. 1985).

[107] *In re Sheldon Transfer & Storage Co., Inc.*, No. 89-40514-JFQ (Bankr. D. Mass. 1992).

The U.S. Supreme Court held, in *Whiting Pools*,[108] that the IRS could not keep property seized prior to the filing of a chapter 11 bankruptcy petition. In this case, the IRS seized the operating assets of the debtor just prior to filing of a reorganization petition. The court held that, under Bankruptcy Code section 542(a), the bankruptcy court has the authority to order the IRS to return the property to the trustee of the reorganized estate even though the debtor no longer had a possessory interest in the property. The court further stated that nothing in the legislative history suggests that Congress intended to permit the IRS to interfere with the reorganization effort by depriving the estate of its assets essential to the rehabilitation effort. The IRS interest, like the interest of other creditors, is adequately protected under the Bankruptcy Code.

(h) Survival of Lien

Most courts have held that the debtor may not obtain an order to compel the IRS to release the liens under I.R.C. section 6325(a)(1) when a valid tax lien exists against the debtors' property for unpaid taxes that were discharged under sections 523(a)(1), 507(a)(7), and 727 of the Bankruptcy Code.

I.R.C. section 6325(a)(1) provides that a lien shall be released when: "The Secretary finds that the liability for the amount assessed . . . has been fully satisfied or has become legally unenforceable." In *In re Robert H. Isom,*[109] the Ninth Circuit held that the liability for the amount assessed remains legally enforceable even where the underlying tax debt is discharged in the bankruptcy proceeding. A discharge in bankruptcy, however, prevents the IRS from taking any action to collect the debt as a personal liability of the debtor.

In *John Braddock v. United States,*[110] the bankruptcy court held that the properly filed tax liens were excepted from the homestead exemption pursuant to 11 U.S.C. 522(c)(2)(B). The IRS did not file an objection to the claim for an exemption of the homestead. The court, however, found that the IRS was not required to file such an objection for the tax lien to survive.

The Braddocks filed their homestead exemption prior to the filing of the tax lien for unpaid FICA taxes. However, the tax lien was filed prior to the filing of the bankruptcy petition. The bankruptcy court held that the "first-in-time" argument with respect to tax liens was without merit and that the Braddocks' reliance on *Crow v. Long*[111] was misplaced.

The bankruptcy court noted that Mrs. Braddock was not listed on the tax notice and she had no interest in the produce business. Thus, the tax lien did not apply to her and she was entitled to her homestead exemption.

Federal tax liens attach to property exempt from an administrative levy under I.R.C. section 6334. Section 6334 exempts from levy, inter alia, the following personal property: wearing apparel, school books, fuel, furniture, tools of a trade, business, or profession, unemployment benefits, undelivered mail,

[108] *United States v. Whiting Pools*, Inc., 462 U.S. 198 (1983).
[109] 901 F.2d 744 (9th Cir. 1990).
[110] Adv. No. 91/00068 (Bankr. D. Mont. Oct. 20, 1992).
[111] 107 B.R. 184 (Bankr. E.D. Mo. 1989).

pension payments, workers' compensation, and judgments for support of minor children.[112]

The Circuit Courts were split on whether section 506(d) of the Bankruptcy Code permits a chapter 7 debtor to avoid tax liens related to taxes that are dischargeable. The Supreme Court looked at the issue in *Dewsnup v. Timm.*[113]

The Supreme Court held that after a property has been abandoned by the trustee, a chapter 7 debtor cannot use section 506(d) of the Bankruptcy Code to strip down an undersecured creditor's lien on real property to the value of the collateral.

Bankruptcy Code section 506 provides in relevant part:

> (A) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.
>
> * * *
>
> (d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

Thus, section 506(a) of the Bankruptcy Code bifurcates claims into secured and unsecured claims, depending on the value of the collateral. Section 506(d) then apparently voids the portion that is not an "allowed secured claim."

In affirming the Tenth Circuit Court of Appeals, the Supreme Court held that section 506(d) does not allow the debtor to "strip down" the creditor's lien to the judicially determined value of the collateral, because the creditor's claim is secured by a lien and has been fully allowed pursuant to section 502 and, therefore, cannot be classified as "not an allowed secured claim" for purposes of the lien-voiding provision of section 506(d). The Supreme Court held that section 506(d) and its relationship to other Bankruptcy Code provisions are ambiguous. The Court reasoned that the words "allowed secured claim" in section 506(d) need not be read as an indivisible term of art defined by reference to section 506(a), but should be read term-by-term to refer to any claim that is, first, allowed, and, second, secured generally.

The Court reasoned that Congress must have enacted the Bankruptcy Code with a full understanding of the rule that liens on real property pass through bankruptcy unaffected, and, given the statutory ambiguity which the majority found, to attribute to Congress the intention to grant a debtor the broad new remedy against allowed claims to the extent that they become "unsecured" for purposes of section 506(a) without mentioning the new remedy somewhere in

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[112] U.S.U. Barbier, 896 F.2d 377 (1990).
[113] 112 S. Ct. 773 (1992).

the Bankruptcy Code or in the legislative history would be implausible and contrary to basic bankruptcy principles.

In footnote 3, the majority stated: "[W]e express no opinion as to whether the words 'allowed secured claim' have different meaning in other provisions of the Bankruptcy Code."

The case is significant in that the court went out of its way to construe statutory language to accommodate the policy that secured real property liens survive bankruptcy intact. The Dewsnup attempt to strip liens on property abandoned by the trustee is only one of debtors' techniques to strip liens. Another technique is for the debtor to obtain a discharge of the debt by liquidating in a chapter 7, but to retain the mortgaged property by curing the defaults in a later filed chapter 13. That is, the debtor uses a chapter 7 to strip away any possible personal liability on a possible deficiency, should the mortgagee prove to be undersecured. Then the debtor uses a chapter 13 to cure and reinstate only the secured portion of the mortgagee's claim. In *Johnson v. Home State Bank,*[114] the Supreme Court held that the Bankruptcy Code did not preclude such "serial filings," but the Court did not reach the question of whether such filings are in good faith. If the Dewsnup case shows the Court's inclination against lien stripping, this bodes well for secured creditors in these other lien-stripping techniques.

In *In re Scott Warner,*[115] the individual debtor attempted to distinguish Dewsnup on the grounds that Dewsnup involved a consensual mortgage lien, while this case involved a nonconsensual tax lien that does not pass through bankruptcy unaffected. The district court, in rejecting the debtor's arguments, noted that the Supreme Court did not limit the application of its analysis to mortgage or consensual liens only. The district court, citing *In re Baund,*[116] noted that, to the extent a tax lien has attached to property before the filing of a petition, a later discharge in bankruptcy does not affect the right of the government to proceed against the property subject to the lien.

In *Richard A. Anderson v. United States,*[117] a Ninth Circuit bankruptcy appellate panel has held that the pension plan was not part of the property in the bankruptcy estate. The court then concluded that the vested right to receive funds prior to the filing of the bankruptcy constituted property or a right to property to which the IRS lien could attach. Richard Anderson had a vested interest of $85,000 in a pension plan and the IRS had filed two tax liens prior to the petition, but had not levied against Anderson's interest in the pension plan.

In *In re Campbell,*[118] the court limited the secured claim to $3,725, which was the Campbells' interest in the properties to which the tax lien attached. The Campbells also owed additional taxes that were not secured. The secured claim was paid in full under the confirmed chapter 13 plan.

[114] 111 S. Ct. 2150 (1991).

[115] No. C-90-20381-RMW (N.D. Cal. 1992).

[116] 289 F. Supp. 604, 607-7 (C.D. Cal. 1969), *aff'd*, 423 F.2d 718 (9th Cir. 1970).

[117] 149 B.R. 591 (Bankr. 9th Cir. 1992).

[118] 160 B.R. 198 (Bankr. M.D. Fla. 1993), *aff'd* 180 B.R. 686 (M.D. Fla. 1995).

The IRS objected to the release of the claim, contending that if the chapter 13 petition were dismissed, the Campbells could encumber their properties in favor of third parties who would have no notice of the government's lien.

Because the government's allowed secured claim was paid in full, the bankruptcy court found no merit in the government's position that the tax lien must remain intact until the unsecured portion of the tax debt is discharged. The court noted that it was "difficult to conceptualize a lien in a vacuum, that is, a lien which does not encumber and attaches to a specific, identifiable property."

In *Nobelman v. American Savings Bank,*[119] the Supreme Court held that a debtor can value the property securing the lien, pay off an amount equal to the value of the secured claim under the chapter 13 plan, and then retain the property free and clear of the lien. Any appreciation in the value of the property goes to the debtor. In the case of a chapter 7 case, the appreciation would go to the creditor. When a secured tax lien is paid off and the debtor retains the property, but the chapter 13 plan is not completed and the petition is dismissed, the courts are split on whether the tax lien remains attached to the asset when the unsecured part of the tax remains unpaid.

In contrast, the bankruptcy court held in *In re Gibbons*[120] that voiding of the tax lien is not allowed until the debtor completes the chapter 13 plan.

In deciding how to handle the issue, some courts have looked at sections 349(b)(1)(C) and 506(d). Section 505(d) provides that, to the extent a lien is not secured by property, it is void. Under section 349(b)(1)(C), a lien that is voided under section 506(d) is reinstated if the case is dismissed. Under chapter 13, when the secured part of the lien is paid, the courts are split as to whether the secured creditor's lien has been satisfied or avoided. In *In re Cooke,*[121] the bankruptcy court held that the lien was satisfied and thus was not reinstated. However, in *In re Scheierl,*[122] the bankruptcy court held that the lien was avoided and thus was reinstated.

The bankruptcy court held that if the chapter 13 secured part of the claim is paid in full before the chapter 13 petition is converted to chapter 7, no additional payments are required to redeem a vehicle from the creditor.[123] However, in *In re Jordan,*[124] the debtor was not entitled to a release of lien when the secured portion of the claim was paid in full before the conversion took place.

In *In re Wessel,*[125] the bankruptcy court held that the government may continue to levy on annuity payments, reasoning that Wessel had a fixed right to receive the payments prior to his filing for bankruptcy. The court noted that, because tax liens attach to all rights to property, the tax liens attached to Wessel's contractual right to receive the payments.

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[119] 113 S. Ct. 2106 (1993).
[120] 164 B.R. 207 (Bankr. D.N.H. 1993).
[121] 169 B.R. 662 (Bankr. W.D. Mo. 1994).
[122] 176 B.R. 498 (Bankr. D. Minn. 1995).
[123] *In re Stoddard*, 167 B.R. 98 (Bankr. S.D. Ohio 1994).
[124] 164 B.R. 89 (Bankr. E.D. Mo. 1994).
[125] 161 B.R. 155 (Bankr. D. S.C. 1993).

George Wessel owed about $26 million in federal income taxes when he filed for bankruptcy protection. Wessel owned a group annuity contract under which he was entitled to receive monthly annuity payments of $7,200 for 97 months. If he died before the expiration of that period, the remainder of the 97 payments were to be made to his beneficiary. Following the expiration of that period in January 1993, Wessel was entitled to receive the monthly payment only for the duration of his life. Prior to filing the bankruptcy petition, the IRS had levied on a portion of those monthly payments. Wessel argued that the levy was illegal because the tax liens did not attach to the postpetition annuity payments, noting that the taxes had been discharged.

The court also rejected Wessel's contention that his staying alive was a condition precedent to receiving the payments. The court noted that a release of the levy on one of the payments had no effect on the IRS's right to collect pursuant to a subsequent levy because the tax liens on the property were never released.

The district court reversed the bankruptcy court's decision in *In re Demarah v. United States*,[126] and held that exempt property was subject to the tax lien for unpaid tax penalties. The court followed the decision in *In re Carlton*,[127] noting that the statutory purpose of section 724(a) of the Bankruptcy Code is to protect unsecured creditors from the debtor's wrongdoing. Allowing Demarah to avoid penalties on taxes does not protect unsecured creditors in this case, because the penalties only impact the amount that the debtor would receive; the property exempt from the bankruptcy estate is out of the reach of the creditors.

The court also held that because the payments under the bankruptcy reorganization were not voluntary, the IRS could apply them as it saw fit. The court also noted that whether the payments were made pre- or postconfirmation was irrelevant to the determination of whether they were voluntary.

The bankruptcy court held that tax liens are not valid against a chapter 13 debtor's residence, because notices of tax liens were not filed until after the debtor elected to exempt his homestead.[128] The court noted other cases in which the courts have held that chapter 13 debtors lack standing to bring avoidance actions.[129] But, citing *In re Perry*,[130] the court ruled that a chapter 13 debtor may avoid tax liens as to exempt property. Thus, the court concluded, because Rogelio elected to exempt his homestead prior to the filing of the notices of tax liens, the liens are not valid against that property, pursuant to section 522(c)(2)(B) of the Bankruptcy Code.

The bankruptcy court held that a chapter 13 debtor's thrift savings plan (TSP) account was attached by a federal tax lien and that the lien was not avoidable.[131] The taxpayer argued that the tax liens did not attach to her TSP account because 5 U.S.C. section 8437(e)(2) states that TSP accounts may not be alienated

[126] 188 B.R. 426 (E.D. Cal. 1993).
[127] 19 B.R. 73 (D. N. Mex. 1982).
[128] *In re Suarez*, 182 B.R. 916 (Bankr. S.D. Fla. 1995).
[129] *In re Tillery*, 124 B.R. 127 (Bankr. M.D. Fla. 1991); *In re Bruce*, 96 B.R. 717 (Bankr. W.D. Tex. 1989); *In re Mast*, 79 B.R. 981 (Bankr. W.D. Mich. 1987).
[130] 90 B.R. 565 (Bankr. S.D. Fla. 1988).
[131] *In re Jones*, 206 B.R. 614 (Bankr. D.D.C. 1997).

and are not subject to execution, levy, attachment, garnishment, or other legal process. The bankruptcy court concluded that 5 U.S.C. section 8437(e)(2) should not be read as an implicit repeal of I.R.C. section 6321, because the two statutes do not conflict irreconcilably. The court reasoned that the TSP statute is susceptible to a reasonable interpretation that does not bar the attachment of the federal tax liens. The court noted that because the tax code does not exempt TSP accounts from tax levies, it is doubtful that Congress intended for the attachment of a federal tax lien to be barred by section 8437(e)(2). The court further noted that the goal of section 8437(e)(2) is to guard against unwise assignments by the employee beneficiary of a TSP account and to safeguard the account from being subject to attack by creditors in general.

(i) Exempt Property

A bankruptcy court held that section 522(c)(2)(B) of the Bankruptcy Code prohibits the avoidance of a properly filed prepetition tax lien on property claimed exempt by the debtor, even if the lien would otherwise have been avoidable under section 522(h).[132] The court concluded that although the levy in this case was a transfer that was potentially avoidable by the trustee, it is not avoidable by the debtor under section 522(h). The bankruptcy court cited *In re Straight*,[133] where the Tenth Circuit held that section 522(c)(2)(B) prohibits the avoidance of a prepetition tax lien on property claimed exempt by a debtor, even if the lien would otherwise be avoidable under section 522(h).

The Fifth Circuit has held that a cause of action held by an insurance agent against State Farm Insurance Co. for its failure to ensure that a Keogh plan complied with the law is property of the agent's bankruptcy estate that is exempt under state (Texas) law.[134]

In *United States v. Parmele,*[135] the district court reversed the bankruptcy court and held the tax claims should not be reduced because the lien to which the taxes relate is exempt property. The bankruptcy court had ruled that the claims could be reduced by $3,226, which was the value assigned to the exempt property. The amount of the claim was $34,624 and the value of the property, including exempt property, to which the IRS had a valid lien was over $35,000.

The district court held that chapter 7 debtors' exempt homestead proceeds were not exempt from IRS tax liens and debtors were not entitled to void the tax liens pursuant to section 506 of the Bankruptcy Code.[136] The court rejected the taxpayers' claim that voiding the tax lien was authorized by section 506. As noted by the court, under section 522(c)(2)(B) of the Bankruptcy Code, exempt property remains subject to debts secured by tax liens. Adopting any other policy, according to the court, would render section 522(c)(2)(B) meaningless and

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[132] *In re Forrest*, 220 B.R. 424 (Bankr. W.D. Okla. 1997); *aff'd* 1998 Bankr. LEXIS 526 (Bankr. 10th Cir. 1998).
[133] 207 B.R. 217 (B.A.P. 10th Cir. 1997).
[134] *In re Swift*, 129 F.3d 792 (5th Cir. 1997).
[135] 71 B.R. 895 (N.D. Okla. 1994).
[136] *In re Stauffer*, 1995 U.S. Dist. LEXIS 8574 (E.D. Cal. 1995).

would allow the more general statute (section 506) to govern the statutory construction of the more specific statute (section 522).

The court also rejected the debtors' assertion that "it would be unjust to allow the United States to benefit from their efforts to have various judicial liens senior to the IRS tax liens voided under [section 506]." Judge Burrell reasoned that "[p]rohibiting the Stauffers from voiding the IRS'[s] tax liens does not allow these liens to 'leap frog' what were previously more senior liens," because the avoided judicial liens "had no equity against which to attach."

The district court upheld the Service's secured claim against a chapter 7 debtor's exempt personal property and affirmed the bankruptcy court's ruling that the debtor lacked standing to challenge a tax lien on exempt property.[137] The court also rejected the debtor's alternative argument that the tax lien was invalid because the IRS had not refiled a notice of lien in a different state to which the debtor had relocated the property. The district court noted that regardless of where the tax lien was filed or recorded, the law created the lien upon assessment of the tax liability.

(i) Impact of Tax Levy

In *In re Nine to Five Child Care*,[138] the bankruptcy court ordered the government to turn over to the trustee funds that the United States received in response to a notice of levy issued in an attempt to collect the debtor's tax debt. The IRS served a notice of levy on the School Board of Palm Beach County (Fla.) in November 1994, seeking payment of amounts that the school board owed to the Nine to Five Child Care Center. Later the same day, Nine to Five filed for chapter 7 bankruptcy protection. The school board issued a check to the IRS for $39,779 in response to the levy nine days after the petition was filed. The bankruptcy court held that the notice of levy did not give the IRS a possessory interest in the funds as it had argued, but rather it protected the IRS against diversion or loss of the funds until priority among creditors could be determined.[139]

[137] *In re Phillips*, 197 B.R. 363 (M.D. Fla. 1996).
[138] 76 AFTR 2d Par 95-5021), Adv. No. 95-0244-BKC-SHF-A (Bankr. S.D. Fla. 1995).
[139] *See In re Challenge Air Int'l Inc.*, 952 F.2d 384 (11th Cir. 1992).

APPENDIX A

Internal Revenue Code: Selected Sections

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SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) *Exclusion from gross income.*

(1) In general. Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness, or

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

(2) Coordination of exclusions.

(A) Title 11 exclusion takes precedence. Subparagraphs (B), (C), and (D) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

- (B) Insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion. Subparagraphs (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.
- (3) Insolvency exclusion limited to amount of insolvency. In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) *Reduction of tax attributes.*

- (1) In general. The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).
- (2) Tax attributes affected; order of reduction. Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:
  - (A) NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
  - (B) General business credit. Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).
  - (C) Minimum tax credit. The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
  - (D) Capital loss carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.
  - (E) Basis reduction.
    - (i) In general. The basis of the property of the taxpayer.
    - (ii) Cross reference. For provisions for making the reduction described in clause (i), see section 1017.
  - (F) Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.
  - (G) Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.
- (3) Amount of reduction.
  - (A) In general. Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).
  - (B) Credit carryover reduction. The reductions described in subparagraphs (B), (C), and (G) shall be 33 1/3 cents for each dollar excluded by subsection (a). The reduction described in subparagraph (F) in any passive activity credit carryover shall be 33 1/3 cents for each dollar excluded by subsection (a).
- (4) Ordering rules.
  - (A) Reductions made after determination of tax for year. The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.
  - (B) Reductions under subparagraph (A) or (D) of paragraph (2). The reductions described in subparagraph (A) or (D) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.
  - (C) Reductions under subparagraphs (B) and (G) of paragraph (2). The reductions described in subparagraphs (B) and (G) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.
- (5) Election to apply reduction first against depreciable property.
  - (A) In general. The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.
  - (B) Limitation. The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer

as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(C) Other tax attributes not reduced. Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

(c) *Treatment of discharge of qualified real property business indebtedness.*

(1) Basis reduction.

(A) In general. The amount excluded from gross income under subparagraph (D) of subsection (a)(1) shall be applied to reduce the basis of the depreciable real property of the taxpayer.

(B) Cross reference. For provisions making the reduction described in subparagraph (A), see section 1017.

(2) Limitations.

(A) Indebtedness in excess of value. The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of—

(i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

(ii) the fair market value of the real property described in paragraph (3)(A) (as of such time), reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

(B) Overall limitation. The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

(3) Qualified real property business indebtedness. The term "qualified real property business indebtedness" means indebtedness which—

(A) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property,

(B) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and

(C) with respect to which such taxpayer makes an election to have this paragraph apply.

Such term shall not include qualified farm indebtedness. Indebtedness under subparagraph (B) shall include indebtedness resulting from the refinancing of indebtedness under subparagraph (B) (or this sentence), but only to the extent it does not exceed the amount of the indebtedness being refinanced.

(4) Qualified acquisition indebtedness. For purposes of paragraph (3)(B), the term "qualified acquisition indebtedness" means, with respect to any real property described in paragraph (3)(A), indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

(5) Regulations. The Secretary shall issue such regulations as are necessary to carry out this subsection, including regulations preventing the abuse of this subsection through cross-collateralization or other means.

(d) *Meaning of terms; special rules relating to certain provisions.*

(1) Indebtedness of taxpayer. For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness—

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case. For purposes of this section, the term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent. For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

(4) Repealed.

(5) Depreciable property. The term "depreciable property" has the same meaning as when used in section 1017.

(6) Certain provisions to be applied at partner level. In the case of a partnership, subsections (a), (b), (c), and (g) shall be applied at the partner level.

(7) Special rules for S corporation.

(A) Certain provisions to be applied at corporate level. In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section.

(B) Reduction in carryover of disallowed losses and deductions. In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

(C) Coordination with basis adjustments under section 1367(b)(2). For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

(8) Reductions of tax attributes in title 11 cases of individuals to be made by estate. In any case under chapter 7 or 11 of title 11 of the United States Code [11 USCS §§ 701 et seq. or 1101 et seq.] to which section 1398 applies, for purposes of paragraphs (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

(9) Time for making election, etc.

(A) Time. An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

(B) Revocation only with consent. An election referred to in subparagraph (A), once made, may be revoked only with the consent of the Secretary.

(C) Manner. An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

(10) Cross reference. For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

(e) *General rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency). For purposes of this title—*

(1) No other insolvency exception. Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

(2) Income not realized to extent of lost deductions. No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

(3) Adjustments for unamortized premium and discount. The amount taken into account with respect to any discharge shall be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.

(4) Acquisition of indebtedness by person related to debtor.

(A) Treated as acquisition by debtor. For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

(B) Members of family. For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

(C) Entities under common control treated as related. For purposes of this paragraph, two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b).

(5) Purchase-money debt reduction for solvent debtor treated as price reduction. If—

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur—

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.

(6) Indebtedness contributed to capital. 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.

(7) Recapture of gain on subsequent sale of stock.

(A) In general. If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245—

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property,

(ii) the aggregate amount allowed to the creditor—

(I) as deductions under subsection (a) or (b) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange,

shall be treated as an amount allowed as a deduction for depreciation, and

(iii) an exchange of such stock qualifying under section 354(a), 355(a), or 356(a) shall be treated as an exchange to which section 1245(b)(3) applies.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) Special rule for cash basis taxpayers. In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(C) Stock of parent corporation. For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(D) Treatment of successor corporation. For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(E) Partnership rule. Under regulations prescribed by the Secretary, rules similar to the rules of the foregoing subparagraphs of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) Indebtedness satisfied by corporation's stock. 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 fair market value of the stock.

(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications. Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

(10) Indebtedness satisfied by issuance of debt instrument.

(A) In general. For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor

shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.

(B) Issue price. For purposes of subparagraph (A), the issue price of any debt instrument shall be determined under sections 1273 and 1274. For purposes of the preceding sentence, section 1273(b)(4) shall be applied by reducing the stated redemption price of any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter.

(11) [Redesignated]

(f) *Student loans.*

(1) In general. In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

(2) Student loan. For purposes of this subsection, the term "student loan" means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by—

(A) the United States, or an instrumentality or agency thereof,

(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,

(C) a public benefit corporation—

(i) which is exempt from taxation under section 501(c)(3),

(ii) which has assumed control over a State, county, or municipal hospital, and

(iii) whose employees have been deemed to be public employees under State law, or

(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made—

(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a).

The term "student loan" includes any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii).

(3) Exception for discharges on account of services performed for certain lenders. Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) if the discharge is on account of services performed for either such organization.

(g) *Special rules for discharge of qualified farm indebtedness.*

(1) Discharge must be by qualified person.

(A) In general. Subparagraph (C) of subsection (a)(1) shall apply only if the discharge is by a qualified person.

(B) Qualified person. For purposes of subparagraph (A), the term "qualified person" has the meaning given to such term by section 49(a)(1)(D)(iv); except that such term shall include any Federal, State, or local government or agency or instrumentality thereof.

(2) Qualified farm indebtedness. For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if—

(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

(3) Amount excluded cannot exceed sum of tax attributes and business and investment assets.
  (A) In general. The amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed the sum of—
    (i) the adjusted tax attributes of the taxpayer, and
    (ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.
  (B) Adjusted tax attributes. For purposes of subparagraph (A), the term "adjusted tax attributes" means the sum of the tax attributes described in subparagraphs (A), (B), (C), (D), (F), and (G) of subsection (b)(2) determined by taking into account $3 for each $1 of the attributes described in subparagraphs (B), (C), and (G) of subsection (b)(2) and the attribute described in subparagraph (F) of subsection (b)(2) to the extent attributable to any passive activity credit carryover.
  (C) Qualified property. For purposes of this paragraph, the term "qualified property" means any property which is used or is held for use in a trade or business or for the production of income.
  (D) Coordination with insolvency exclusion. For purposes of this paragraph, the adjusted basis of any qualified property and the amount of the adjusted tax attributes shall be determined after any reduction under subsection (b) by reason of amounts excluded from gross income under subsection (a)(1)(B).

SEC. 1017. DISCHARGE OF INDEBTEDNESS.

(a) *General rule. If—*
  (1) an amount is excluded from gross income under subsection (a) of section 108 (relating to discharge of indebtedness), and
  (2) under subsection (b)(2)(E), (b)(5), or (c)(1) of section 108, any portion of such amount is to be applied to reduce basis,

  then such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.

(b) *Amount and properties determined under regulations.*
  (1) In general. The amount of reduction to be applied under subsection (a) (not in excess of the portion referred to in subsection (a)), and the particular properties the bases of which are to be reduced, shall be determined under regulations prescribed by the Secretary.
  (2) Limitation in title 11 case or insolvency. In the case of a discharge to which subparagraph (A) or (B) of section 108(a)(1) applies, the reduction in basis under subsection (a) of this section shall not exceed the excess of—
    (A) the aggregate of the bases of the property held by the taxpayer immediately after the discharge, over
    (B) the aggregate of the liabilities of the taxpayer immediately after the discharge.

    The preceding sentence shall not apply to any reduction in basis by reason of an election under section 108(b)(5).
  (3) Certain reductions may only be made in the basis of depreciable property.
    (A) In general. Any amount which under subsection (b)(5) or (c)(1) of section 108 is to be applied to reduce basis shall be applied only to reduce the basis of depreciable property held by the taxpayer.
    (B) Depreciable property. For purposes of this section, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if a basis reduction under subsection (a) will reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction.
    (C) Special rule for partnership interests. For purposes of this section, any interest of a partner in a partnership shall be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by such partnership. The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.
    (D) Special rule in case of affiliated group. For purposes of this section, if—
      (i) a corporation holds stock in another corporation (hereinafter in this subparagraph referred to as the "subsidiary"), and

(ii) such corporations are members of the same affiliated group which file a consolidated return under section 1501 for the taxable year in which the discharge occurs,

then such stock shall be treated as depreciable property to the extent that such subsidiary consents to a corresponding reduction in the basis of its depreciable property.

(E) Election to treat certain inventory as depreciable property.

(i) In general. At the election of the taxpayer, for purposes of this section, the term "depreciable property" includes any real property which is described in section 1221(a)(1).

(ii) Election. An election under clause (i) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary. Such an election, once made, may be revoked only with the consent of the Secretary.

(F) Special rules for qualified real property business indebtedness. In the case of any amount which under section 108(c)(1) is to be applied to reduce basis—

(i) depreciable property shall only include depreciable real property for purposes of subparagraphs (A) and (C),

(ii) subparagraph (E) shall not apply, and

(iii) in the case of property taken into account under section 108(c)(2)(B), the reduction with respect to such property shall be made as of the time immediately before disposition if earlier than the time under subsection (a).

(4) Special rules for qualified farm indebtedness.

(A) In general. Any amount which under subsection (b)(2)(E) of section 108 is to be applied to reduce basis and which is attributable to an amount excluded under subsection (a)(1)(C) of section 108—

(i) shall be applied only to reduce the basis of qualified property held by the taxpayer, and

(ii) shall be applied to reduce the basis of qualified property in the following order:

(I) First the basis of qualified property which is depreciable property.

(II) Second the basis of qualified property which is land used or held for use in the trade or business of farming.

(III) Then the basis of other qualified property.

(B) Qualified property. For purposes of this paragraph, the term "qualified property" has the meaning given to such term by section 108(g)(3)(C).

(C) Certain rules made applicable. Rules similar to the rules of subparagraphs (C), (D), and (E) of paragraph (3) shall apply for purposes of this paragraph and section 108(g).

(c) *Special rules.*

(1) Reduction not to be made in exempt property. In the case of an amount excluded from gross income under section 108(a)(1)(A), no reduction in basis shall be made under this section in the basis of property which the debtor treats as exempt property under section 522 of title 11 of the United States Code.

(2) Reductions in basis not treated as dispositions. For purposes of this title, a reduction in basis under this section shall not be treated as a disposition.

(d) *Recapture of reductions.*

(1) In general. For purposes of sections 1245 and 1250—

(A) any property the basis of which is reduced under this section and which is neither section 1245 property nor section 1250 property shall be treated as section 1245 property, and

(B) any reduction under this section shall be treated as a deduction allowed for depreciation.

(2) Special rule for section 1250. For purposes of section 1250(b), the determination of what would have been the depreciation adjustments under the straight line method shall be made as if there had been no reduction under this section.

SEC. 1398. RULES RELATING TO INDIVIDUALS' TITLE 11 CASES.

(a) *Cases to which section applies.* Except as provided in subsection (b), this section shall apply to any case under chapter 7 [11 USCS §§ 701 et seq.] (relating to liquidations) or chapter 11 [11 USCS §§ 1101 et seq.] (relating to reorganizations) of title 11 of the United States Code in which the debtor is an individual.

(b) *Exceptions where case is dismissed, etc.*
  (1) Section does not apply where case is dismissed. This section shall not apply if the case under chapter 7 or 11 of title 11 of the United States Code [11 USCS §§ 701 et seq. or 1101 et seq.] is dismissed.
  (2) Section does not apply at partnership level. For purposes of subsection (a), a partnership shall not be treated as an individual, but the interest in a partnership of a debtor who is an individual shall be taken into account under this section in the same manner as any other interest of the debtor.

(c) *Computation and payment of tax; basic standard deduction.*
  (1) Computation and payment of tax. Except as otherwise provided in this section, the taxable income of the estate shall be computed in the same manner as for an individual. The tax shall be computed on such taxable income and shall be paid by the trustee.
  (2) Tax rates. The tax on the taxable income of the estate shall be determined under subsection (d) of section 1.
  (3) Basic standard deduction. In the case of an estate, which does not itemize deductions, the basic standard deduction for the estate for the taxable year shall be the same as for a married individual filing a separate return for such year.

(d) *Taxable year of debtors.*
  (1) General rule. Except as provided in paragraph (2), the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.
  (2) Election to terminate debtor's year when case commences.
    (A) In general. Notwithstanding section 442, the debtor may (without the approval of the Secretary) elect to treat the debtor's taxable year, which includes the commencement date as 2 taxable years—
      (i) the first of which ends on the day before the commencement date, and
      (ii) the second of which begins on the commencement date.
    (B) Spouse may join in election. In the case of a married individual (within the meaning of section 7703), the spouse may elect to have the debtor's election under subparagraph (A) also apply to the spouse, but only if the debtor and the spouse file a joint return for the taxable year referred to in subparagraph (A)(i).
    (C) No election where debtor has no assets. No election may be made under subparagraph (A) by a debtor who has no assets other than property, which the debtor may treat as exempt property under section 522 of title 11 of the United States Code.
    (D) Time for making election. An election under subparagraph (A) or (B) may be made only on or before the due date for filing the return for the taxable year referred to in subparagraph (A)(i). Any such election, once made, shall be irrevocable.
    (E) Returns. A return shall be made for each of the taxable years specified in subparagraph (A).
    (F) Annualization. For purposes of subsections (b), (c), and (d) of section 443, a return filed for either of the taxable years referred to in subparagraph (A) shall be treated as a return made under paragraph (1) of subsection (a) of section 443.
  (3) Commencement date defined. For purposes of this subsection, the term "commencement date" means the day on which the case under title 11 of the United States Code to which this section applies commences.

(e) *Treatment of income, deductions, and credits.*
  (1) Estate's share of debtor's income. The gross income of the estate for each taxable year shall include the gross income of the debtor to which the estate is entitled under title 11 of the United States Code. The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date (as defined in subsection (d)(3)).
  (2) Debtor's share of debtor's income. The gross income of the debtor for any taxable year shall not include any item to the extent that such item is included in the gross income of the estate by reason of paragraph (1).
  (3) Rule for making determinations with respect to deductions, credits, and employment taxes. Except as otherwise provided in this section, the determination of whether or not any amount paid or incurred by the estate—
    (A) is allowable as a deduction or credit under this chapter, or
    (B) is wages for purposes of subtitle C,

shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses, and in the activities, the debtor was engaged in before the commencement of the case.

(f) *Treatment of transfers between debtor and estate.*

(1) Transfer to estate not treated as disposition. A transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the estate shall be treated as the debtor would be treated with respect to such asset.

(2) Transfer from estate to debtor not treated as disposition. In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset.

(g) *Estate succeeds to tax attributes of debtor.* The estate shall succeed to and take into account the following items (determined as of the first day of the debtor's taxable year in which the case commences) of the debtor—

(1) Net operating loss carryovers. The net operating loss carryovers determined under section 172.

(2) Charitable contributions carryovers. The carryover of excess charitable contributions determined under section 170(d)(1).

(3) Recovery of tax benefit items. Any amount to which section 111 (relating to recovery of tax benefit items) applies.

(4) Credit carryovers, etc. The carryovers of any credit, and all other items which, but for the commencement of the case, would be required to be taken into account by the debtor with respect to any credit.

(5) Capital loss carryovers. The capital loss carryover determined under section 1212.

(6) Basis, holding period, and character of assets. In the case of any asset acquired (other than by sale or exchange) by the estate from the debtor, the basis, holding period, and character it had in the hands of the debtor.

(7) Method of accounting. The method of accounting used by the debtor.

(8) Other attributes. Other tax attributes of the debtor, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section.

(h) *Administration, liquidation, and reorganization expenses; carryovers and carrybacks of certain excess expenses.*

(1) Administration, liquidation, and reorganization expenses. Any administrative expense allowed under section 503 of title 11 of the United States Code, and any fee or charge assessed against the estate under chapter 123 of title 28 of the United States Code [28 USCS §§ 1911 et seq.], to the extent not disallowed under any other provision of this title, shall be allowed as a deduction.

(2) Carryback and carryover of excess administrative costs, etc., to estate taxable years.

(A) Deduction allowed. There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (i) the administrative expense carryovers to such year, plus (ii) the administrative expense carrybacks to such year.

(B) Administrative expense loss, etc. If a net operating loss would be created or increased for any estate taxable year if section 172(c) were applied without the modification contained in paragraph (4) of section 172(d), then the amount of the net operating loss so created (or the amount of the increase in the net operating loss) shall be an administrative expense loss for such taxable year which shall be an administrative expense carryback to each of the 3 preceding taxable years and an administrative expense carryover to each of the 7 succeeding taxable years.

(C) Determination of amount carried to each taxable year. The portion of any administrative expense loss which may be carried to any other taxable year shall be determined under section 172(b)(2), except that for each taxable year the computation under section 172(b)(2) with respect to the net operating loss shall be made before the computation under this paragraph.

(D) Administrative expense deductions allowed only to estate. The deductions allowable under this chapter solely by reason of paragraph (1), and the deduction provided by subparagraph (A) of this paragraph, shall be allowable only to the estate.

(i) *Debtor succeeds to tax attributes of estate.* In the case of a termination of an estate, the debtor shall succeed to and take into account the items referred to in paragraphs (1), (2), (3), (4), (5), and (6) of subsection (g) in a manner similar to that provided in such paragraphs (but taking into account that the transfer is from the estate to the debtor instead of from the debtor to the estate). In addition, the debtor shall succeed to and take into account the other tax attributes of the estate, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section.

(j) *Other special rules.*
- (1) Change of accounting period without approval. Notwithstanding section 442, the estate may change its annual accounting period one time without the approval of the Secretary.
- (2) Treatment of certain carrybacks.
  - (A) Carrybacks from estate. If any carryback year of the estate is a taxable year before the estate's first taxable year, the carryback to such carryback year shall be taken into account for the debtor's taxable year corresponding to the carryback year.
  - (B) Carrybacks from debtor's activities. The debtor may not carry back to a taxable year before the debtor's taxable year in which the case commences any carryback from a taxable year ending after the case commences.
  - (C) Carryback and carryback year defined. For purposes of this paragraph—
    - (i) Carryback. The term "carryback" means a net operating loss carryback under section 172 or a carryback of any credit provided by part IV of subchapter A.
    - (ii) Carryback year. The term "carryback year" means the taxable year to which a carryback is carried.

SEC. 1399. NO SEPARATE TAXABLE ENTITIES FOR PARTNERSHIPS, CORPORATIONS, ETC.

Except in any case to which section 1398 applies, no separate taxable entity shall result from the commencement of a case under title 11 of the United States Code.

SEC. 6103 CONFIDENTIALITY AND DISCLOSURE OF RETURNS AND RETURN INFORMATION.

(e) *Disclosure to Persons Having Material Interest.*
- (4) Title 11 cases and receivership proceedings. If
  - (A) there is a trustee in a title 11 case in which the debtor is the person with respect to whom the return is filed, or
  - (B) substantially all of the property of the person with respect to whom the return is filed is in the hands of a receiver, such return or returns for prior years of such person shall, upon written request, be open to inspection by or disclosure to such trustee or receiver, but only if the Secretary finds that such trustee or receiver, in his fiduciary capacity, has a material interest which will be affected by information contained therein.
- (5) Individual's title 11 case.
  - (A) In general. In any case to which section 1398 applies (determined without regard to section 1398(b)(1)), any return of the debtor for the taxable year in which the case commenced or any preceding taxable year shall, upon written request, be open to inspection by or disclosure to the trustee in such case.
  - (B) Return of estate available to debtor. Any return of an estate in a case to which section 1398 applies shall, upon written request, be open to inspection by or disclosure to the debtor in such case.
  - (C) Special rule for involuntary cases. In an involuntary case, no disclosure shall be made under subparagraph (A) until the order for relief has been entered by the court having jurisdiction of such case unless such court finds that such disclosure is appropriate for purposes of determining whether an order for relief should be entered.

SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(l) Discharge of Indebtedness Income.
- (1) Does not increase earnings and profits if applied to reduce basis. The earnings and profits of a corporation shall not include from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017.
- (2) Reduction of deficit in earnings and profits in certain cases. If

(A) the interest of any shareholder of a corporation is terminated or extinguished in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), and
(B) there is a deficit in the earnings and profits of the corporation, then such deficit shall be reduced by an amount equal to the paid-in capital which is allocable to the interest of the shareholder which is so terminated or extinguished.

SEC. 331. GAIN OR LOSS TO SHAREHOLDERS IN CORPORATE LIQUIDATIONS.

(a) *Distributions in Complete Liquidation Treated as Exchanges.* Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.
(b) *Nonapplication of Section 301.* Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property (other than a distribution referred to in paragraph (2)(B) of section 316(b)), in complete liquidation.
(c) *Cross Reference.*
For general rule for determination of the amount of gain or loss recognized, see section 1001.

§ 332. COMPLETE LIQUIDATIONS OF SUBSIDIARIES.

(a) *General rule.* No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.
(b) *Liquidations to which section applies.* For purposes of this section, a distribution shall be considered to be in complete liquidation only if—
    (1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of section 1504(a)(2); and either
    (2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or
    (3) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

    If such transfer of all the property does not occur within the taxable year, the Secretary may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such 3-year period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, the assessment and collection of all income taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this subsection shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for purposes of this subsection a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (A) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, on an exchange described in section 361, and (B) the complete cancellation or redemption under the plan, as a result of exchanges described in section 354, of the shares not owned by the taxpayer.
(c) *Deductible liquidating distributions of regulated investment companies and real estate investment trusts.* If a corporation receives a distribution from a regulated investment company or a real estate

investment trust which is considered under subsection (b) as being in complete liquidation of such company or trust, then, notwithstanding any other provision of this chapter, such corporation shall recognize and treat as a dividend from such company or trust an amount equal to the deduction for dividends paid allowable to such company or trust by reason of such distribution.

SEC. 336. GAIN OR LOSS RECOGNIZED ON PROPERTY DISTRIBUTED IN COMPLETE LIQUIDATION.

(a) *General Rule.* Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.

(b) *Treatment of Liabilities.* If any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, for purposes of subsection (a) and section 337, the fair market value of such property shall be treated as not less than the amount of such liability.

(c) *Exception for Liquidations Which Are Part of a Reorganization.* For provision providing that this subpart does not apply to distributions in pursuance of a plan of reorganization, see section 361(c)(4).

(d) *Limitations on Recognition of Loss.*

(1) No loss recognized in certain distributions to related persons.

(A) In general. No loss shall be recognized to a liquidating corporation on the distribution of any property to a related person (within the meaning of section 267) if

(i) such distribution is not pro rata, or

(ii) such property is disqualified property.

(B) Disqualified property. For purposes of subparagraph (A), the term "disqualified property" means any property, which is acquired by the liquidating corporation in a transaction to which section 351 applied, or as a contribution to capital, during the 5-year period ending on the date of the distribution. Such term includes any property if the adjusted basis of such property is determined (in whole or in part) by reference to the adjusted basis of property described in the preceding sentence.

(2) Special rule for certain property acquired in certain carryover basis transactions.

(A) In general. For purposes of determining the amount of loss recognized by any liquidating corporation on any sale, exchange, or distribution of property described in subparagraph (B), the adjusted basis of such property shall be reduced (but not below zero) by the excess (if any) of

(i) the adjusted basis of such property immediately after its acquisition by such corporation, over

(ii) the fair market value of such property as of such time.

(B) Description of property.

(i) In general. For purposes of subparagraph (A), property is described in this subparagraph if

(I) such property is acquired by the liquidating corporation in a transaction to which section 351 applied or as a contribution to capital, and

(II) the acquisition of such property by the liquidating corporation was part of a plan a principal purpose of which was to recognize loss by the liquidating corporation with respect to such property in connection with the liquidation.

Other property shall be treated as so described if the adjusted basis of such other property is determined (in whole or in part) by reference to the adjusted basis of property described in the preceding sentence.

(ii) Certain acquisitions treated as part of plan. For purposes of clause (i), any property described in clause (i)(I) acquired by the liquidated corporation after the date 2 years before the date of the adoption of the plan of complete liquidation shall, except as provided in regulations, be treated as acquired as part of a plan described in clause (i)(II).

(C) Recapture in lieu of disallowance. The Secretary may prescribe regulations under which, in lieu of disallowing a loss under subparagraph (A) for a prior taxable year, the gross income of the liquidating corporation for the taxable year in which the plan of complete liquidation is adopted shall be increased by the amount of the disallowed loss.

(3) Special rule in case of liquidation to which section 332 applies. In the case of any liquidation to which section 332 applies, no loss shall be recognized to the liquidating corporation on any distribution in such liquidation. The preceding sentence shall apply to any distribution to the 80-percent distributee only if subsection (a) or (b)(1) of section 337 applies to such distribution.

(e) *Certain Stock Sales and Distributions May Be Treated as Asset Transfers.* Under regulations prescribed by the Secretary, if

(1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and

(2) such corporation sells, exchanges, or distributes all of such stock, an election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.

SEC. 337. NONRECOGNITION FOR PROPERTY DISTRIBUTED TO PARENT IN COMPLETE LIQUIDATION OF SUBSIDIARY.

(a) *In general.* No gain or loss shall be recognized to the liquidating corporation on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies.

(b) *Treatment of Indebtedness of Subsidiary, Etc.*

(1) Indebtedness of subsidiary to parent. If

(A) a corporation is liquidated in a liquidation to which section 332 applies, and

(B) on the date of the adoption of the plan of liquidation, such corporation was indebted to the 80-percent distributee.

for purposes of this section and section 336, any transfer of property to the 80-percent distributee in satisfaction of such indebtedness shall be treated as a distribution to such distributee in such liquidation.

(2) Treatment of tax-exempt distributee.

(A) In general. Except as provided in subparagraph (B), paragraph (1) and subsection (a) shall not apply where the 80-percent distributee is an organization (other than a cooperative described in section 521, which is exempt from the tax imposed by this chapter.

(B) Exception where property will be used in unrelated business.

(i) In general. Subparagraph (A) shall not apply to any distribution of property to an organization described in section 511(a)(2) if, immediately after such distribution, such organization uses such property in an activity the income from which is subject to tax under 511(a).

(ii) Later disposition or change in use. If any property to which clause (i) applied is disposed of by the organization acquiring such property, notwithstanding any other provision of law, any gain (not in excess of the amount not recognized by reason of clause (i)) shall be included in such organization's unrelated business taxable income. For purposes of the preceding sentence, if such property ceases to be used in an activity referred to in clause (i), such organization shall be treated as having disposed of such property on the date of such cessation.

(c) *80-Percent Distributee.* For purposes of this section, the term "80-percent distributee" means only the corporation, which meets the 80-percent stock ownership requirements specified in section 332(b). For purposes of this section, the determination of whether any corporation is an 80-percent distributee shall be made without regard to any consolidated return regulation.

(d) *Regulations.* The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including

(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax exempt entity, and

(2) regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.

SEC. 338. CERTAIN STOCK PURCHASES TREATED AS ASSET ACQUISITIONS.

(a) *General rule.* For purposes of this subtitle, if a purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such an election), then, in the case of any qualified stock purchase, the target corporation—
  (1) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and
  (2) shall be treated as a new corporation which purchased all of the assets referred to in paragraph (1) as of the beginning of the day after the acquisition date.

(b) *Basis of assets after deemed purchase.*
  (1) In general. For purposes of subsection (a), the assets of the target corporation shall be treated as purchased for an amount equal to the sum of —
    (A) the grossed-up basis of the purchasing corporation's recently purchased stock, and
    (B) the basis of the purchasing corporation's nonrecently purchased stock.
  (2) Adjustment for liabilities and other relevant items. The amount described in paragraph (1) shall be adjusted under regulations prescribed by the Secretary for liabilities of the target corporation and other relevant items.
  (3) Election to step-up the basis of certain target stock.
    (A) In general. Under regulations prescribed by the Secretary, the basis of the purchasing corporation's nonrecently purchased stock shall be the basis amount determined under subparagraph (B) of this paragraph if the purchasing corporation makes an election to recognize gain as if such stock were sold on the acquisition date for an amount equal to the basis amount determined under subparagraph (B).
    (B) Determination of basis amount. For purposes of subparagraph (A), the basis amount determined under this subparagraph shall be an amount equal to the grossed-up basis determined under subparagraph (A) of paragraph (1) multiplied by a fraction—
      (i) the numerator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and
      (ii) the denominator of which is 100 percent minus the percentage referred to in clause (i).
  (4) Grossed-up basis. For purposes of paragraph (1), the grossed-up basis shall be an amount equal to the basis of the corporation's recently purchased stock, multiplied by a fraction—
    (A) the numerator of which is 100 percent, minus the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock, and
    (B) the denominator of which is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's recently purchased stock.
  (5) Allocation among assets. The amount determined under paragraphs (1) and (2) shall be allocated among the assets of the target corporation under regulations prescribed by the Secretary.
  (6) Definitions of recently purchased stock and nonrecently purchased stock. For purposes of this subsection—
    (A) Recently purchased stock. The term "recently purchased stock" means any stock in the target corporation which is held by the purchasing corporation on the acquisition date and which was purchased by such corporation during the 12-month acquisition period.
    (B) Nonrecently purchased stock. The term "nonrecently purchased stock" means any stock in the target corporation, which is held by the purchasing corporation on the acquisition date and which is not recently purchased stock.

(c) *Repealed.*

(d) *Purchasing corporation; target corporation; qualified stock purchase.* For purposes of this section—
  (1) Purchasing corporation. The term "purchasing corporation" means any corporation which makes a qualified stock purchase of stock of another corporation.
  (2) Target corporation. The term "target corporation" means any corporation the stock of which is acquired by another corporation in a qualified stock purchase.
  (3) Qualified stock purchase. The term "qualified stock purchase" means any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of 1

corporation is acquired by another corporation by purchase during the 12-month acquisition period.

(e) *Deemed election where purchasing corporation acquires asset of target corporation.*

(1) In general. A purchasing corporation shall be treated as having made an election under this section with respect to any target corporation if, at any time during the consistency period, it acquires any asset of the target corporation (or a target affiliate).

(2) Exceptions. Paragraph (1) shall not apply with respect to any acquisition by the purchasing corporation if—

(A) such acquisition is pursuant to a sale by the target corporation (or the target affiliate) in the ordinary course of its trade or business,

(B) the basis of the property acquired is determined wholly by reference to the adjusted basis of such property in the hands of the person from whom acquired,

(C) such acquisition was before September 1, 1982, or

(D) such acquisition is described in regulations prescribed by the Secretary and meets such conditions as such regulations may provide.

(3) Anti-avoidance rule. Whenever necessary to carry out the purpose of this subsection and subsection (f), the Secretary may treat stock acquisitions which are pursuant to a plan and which meet the requirements of section 1504(a)(2) as qualified stock purchases.

(f) *Consistency required for all stock acquisitions from same affiliated group.* If a purchasing corporation makes qualified stock purchases with respect to the target corporation and 1 or more target affiliates during any consistency period, then (except as otherwise provided in subsection (e))—

(1) any election under this section with respect to the first such purchase shall apply to each other such purchase, and

(2) no election may be made under this section with respect to the second or subsequent such purchase if such an election was not made with respect to the first such purchase.

(g) *Election*.

(1) When made. Except as otherwise provided in regulations, an election under this section shall be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(2) Manner. An election by the purchasing corporation under this section shall be made in such manner as the Secretary shall by regulations prescribe.

(3) Election irrevocable. An election by a purchasing corporation under this section, once made, shall be irrevocable.

(h) *Definitions and special rules.* For purposes of this section—

(1) 12-month acquisition period. The term “12-month acquisition period” means the 12-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase (or, if any of such stock was acquired in an acquisition which is a purchase by reason of subparagraph (C) of paragraph (3), the date on which the acquiring corporation is first considered under section 318(a) (other than paragraph (4) thereof) as owning stock owned by the corporation from which such acquisition was made).

(2) Acquisition date. The term “acquisition date” means, with respect to any corporation, the first day on which there is a qualified stock purchase with respect to the stock of such corporation.

(3) Purchase.

(A) In general. The term “purchase” means any acquisition of stock, but only if—

(i) the basis of the stock in the hands of the purchasing corporation is not determined (I) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (II) under section 1014(a) (relating to property acquired from a decedent),

(ii) the stock is not acquired in an exchange to which section 351, 354, 355, or 356 applies and is not acquired in any other transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized on the transaction, and

(iii) the stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to the person acquiring such stock.

(B) Deemed purchase under subsection (a). The term “purchase” includes any deemed purchase under subsection (a)(2). The acquisition date for a corporation which is

deemed purchased under subsection (a)(2) shall be determined under regulations prescribed by the Secretary.

(C) Certain stock acquisitions from related corporations.

(i) In general. Clause (iii) of subparagraph (A) shall not apply to an acquisition of stock from a related corporation if at least 50 percent in value of the stock of such related corporation was acquired by purchase (within the meaning of subparagraphs (A) and (B)).

(ii) Certain distributions. Clause (i) of subparagraph (A) shall not apply to an acquisition of stock described in clause (i) of this subparagraph if the corporation acquiring such stock—

(I) made a qualified stock purchase of stock of the related corporation, and

(II) made an election under this section (or is treated under subsection (e) as having made such an election) with respect to such qualified stock purchase.

(iii) Related corporation defined. For purposes of this subparagraph, a corporation is a related corporation if stock owned by such corporation is treated (under section 318(a) other than paragraph (4) thereof) as owned by the corporation acquiring the stock.

(4) Consistency period.

(A) In general. Except as provided in subparagraph (B), the term "consistency period" means the period consisting of—

(i) the 1-year period before the beginning of the 12-month acquisition period for the target corporation,

(ii) such acquisition period (up to and including the acquisition date), and

(iii) the 1-year period beginning on the day after the acquisition date.

(B) Extension where there is plan. The period referred to in subparagraph (A) shall also include any period during which the Secretary determines that there was in effect a plan to make a qualified stock purchase plus 1 or more other qualified stock purchases (or asset acquisitions described in subsection (e)) with respect to the target corporation or any target affiliate.

(5) Affiliated group. The term "affiliated group" has the meaning given to such term by section 1504(a) (determined without regard to the exceptions contained in section 1504(b)).

(6) Target affiliate.

(A) In general. A corporation shall be treated as a target affiliate of the target corporation if each of such corporations was, at any time during so much of the consistency period as ends on the acquisition date of the target corporation, a member of an affiliated group which had the same common parent.

(B) Certain foreign corporations, etc. Except as otherwise provided in regulations (and subject to such conditions as may be provided in regulations)—

(i) the term "target affiliate" does not include a foreign corporation, a DISC, or a corporation to which an election under section 936 applies, and

(ii) stock held by a target affiliate in a foreign corporation or a domestic corporation which is a DISC or described in section 1248(e) shall be excluded from the operation of this section.

(7) Repealed.

(8) Acquisitions by affiliated group treated as made by 1 corporation. Except as provided in regulations prescribed by the Secretary, stock and asset acquisitions made by members of the same affiliated group shall be treated as made by 1 corporation.

(9) Target not treated as member of affiliated group. Except as otherwise provided in paragraph (10) or in regulations prescribed under this paragraph, the target corporation shall not be treated as a member of an affiliated group with respect to the sale described in subsection (a)(1).

(10) Elective recognition of gain or loss by target corporation, together with nonrecognition of gain or loss on stock sold by selling consolidated group.

(A) In general. Under regulations prescribed by the Secretary, an election may be made under which if—

(i) the target corporation was, before the transaction, a member of the selling consolidated group, and

(ii) the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction,

then the target corporation shall be treated as a member of the selling consolidated group with respect to such sale, and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.

(B) Selling consolidated group. For purposes of subparagraph (A), the term "selling consolidated group" means any group of corporations which (for the taxable period which includes the transaction)—

(i) includes the target corporation, and

(ii) files a consolidated return.

To the extent provided in regulations, such term also includes any affiliated group of corporations which includes the target corporation (whether or not such group files a consolidated return).

(C) Information required to be furnished to the secretary. Under regulations, where an election is made under subparagraph (A), the purchasing corporation and the common parent of the selling consolidated group shall, at such times and in such manner as may be provided in regulations, furnish to the Secretary the following information:

(i) The amount allocated under subsection (b)(5) to goodwill or going concern value.

(ii) Any modification of the amount described in clause (i).

(iii) Any other information as the Secretary deems necessary to carry out the provisions of this paragraph.

(11) Elective formula for determining fair market value. For purposes of subsection (a)(1), fair market value may be determined on the basis of a formula provided in regulations prescribed by the Secretary, which takes into account liabilities and other relevant items.

(12) Repealed.

(13) Tax on deemed sale not taken into account for estimated tax purposes. For purposes of section 6655, tax attributable to the sale described in subsection (a)(1) shall not be taken into account.

(14) Deleted.

(15) Combined deemed sale return. Under regulations prescribed by the Secretary, a combined deemed sale return may be filed by all target corporations acquired by a purchasing corporation on the same acquisition date if such target corporations were members of the same selling consolidated group (as defined in subparagraph (B) of paragraph (10)).

(16) Coordination with foreign tax credit provisions. Except as provided in regulations, this section shall not apply for purposes of determining the source or character of any item for purposes of subpart A of part III of subchapter N of this chapter (relating to foreign tax credit). The preceding sentence shall not apply to any gain to the extent such gain is includible in gross income as a dividend under section 1248 (determined without regard to any deemed sale under this section by a foreign corporation).

(i) *Regulations*. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including—

(1) regulations to ensure that the purpose of this section to require consistency of treatment of stock and asset sales and purchases may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations) and

(2) regulations providing for the coordination of the provisions of this section with the provision of this title relating to foreign corporations and their shareholders.

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) *General rule.* No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) *Receipt of property.* If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) *Special rules where distribution to shareholders.*

(1) In general. In determining control for purposes of this section, the fact that any corporate transferor distributes part or all of the stock in the corporation, which it receives in the exchange to its shareholders shall not be taken into account.

(2) Special rule for section 355. If the requirements of section 355 (or so much of section 356 as relates to section 355) are met with respect to a distribution described in paragraph (1), then, solely for purposes of determining the tax treatment of the transfers of property to the controlled corporation by the distributing corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account in determining control for purposes of this section.

(d) *Services, certain indebtedness, and accrued interest not treated as property.* For purposes of this section, stock issued for—

(1) services,

(2) indebtedness of the transferee corporation which is not evidenced by a security, or

(3) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt,

shall not be considered as issued in return for property.

(e) *Exceptions.* This section shall not apply to—

(1) Transfer of property to an investment company. A transfer of property to an investment company. For purposes of the preceding sentence, the determination of whether a company is an investment company shall be made—

(A) by taking into account all stock and securities held by the company, and

(B) by treating as stock and securities—

(i) money,

(ii) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives,

(iii) any foreign currency,

(iv) any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly-traded partnership (as defined in section 7704(b)) or any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any preceding clause, this clause or clause (v) or (viii),

(v) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution,

(vi) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any preceding clause or clause (viii),

(vii) to the extent provided in regulations prescribed by the Secretary, any interest in any entity not described in clause (vi), but only to the extent of the value of such interest that is attributable to assets listed in clauses (i) through (v) or clause (viii), or

(viii) any other asset specified in regulations prescribed by the Secretary.

The Secretary may prescribe regulations that, under appropriate circumstances, treat any asset described in clauses (i) through (v) as not so listed.

(2) Title 11 or similar case. A transfer of property of a debtor pursuant to a plan while the debtor is under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), to the extent that the stock received in the exchange is used to satisfy the indebtedness of such debtor.

(f) *Treatment of controlled corporation.* If—

(1) property is transferred to a corporation (hereinafter in this subsection referred to as the "controlled corporation") in an exchange with respect to which gain or loss is not recognized (in whole or in part) to the transferor under this section, and

- (2) such exchange is not in pursuance of a plan of reorganization, section 311 shall apply to any transfer in such exchange by the controlled corporation in the same manner as if such transfer were a distribution to which subpart A of part I applies.

(g) *Nonqualified preferred stock not treated as stock.*

- (1) In general. In the case of a person who transfers property to a corporation and receives nonqualified preferred stock—
  - (A) subsection (a) shall not apply to such transferor, and
  - (B) if (and only if) the transferor receives stock other than nonqualified preferred stock—
    - (i) subsection (b) shall apply to such transferor; and
    - (ii) such nonqualified preferred stock shall be treated as other property for purposes of applying subsection (b).
- (2) Nonqualified preferred stock. For purposes of paragraph (1)—
  - (A) In general. The term "nonqualified preferred stock" means preferred stock if—
    - (i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock,
    - (ii) the issuer or a related person is required to redeem or purchase such stock,
    - (iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or
    - (iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.
  - (B) Limitations. Clauses (i), (ii), and (iii) of subparagraph (A) shall apply only if the right or obligation referred to therein may be exercised within the 20-year period beginning on the issue date of such stock and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.
  - (C) Exceptions for certain rights or obligations.
    - (i) In general. A right or obligation shall not be treated as described in clause (i), (ii), or (iii) of subparagraph (A) if—
      - (I) it may be exercised only upon the death, disability, or mental incompetency of the holder, or
      - (II) in the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or a related person.
    - (ii) Exception. Clause (i)(I) shall not apply if the stock relinquished in the exchange, or the stock acquired in the exchange is in—
      - (I) a corporation if any class of stock in such corporation or a related party is readily tradable on an established securities market or otherwise, or
      - (II) any other corporation if such exchange is part of a transaction or series of transactions in which such corporation is to become a corporation described in subclause (I).
- (3) Definitions. For purposes of this subsection—
  - (A) Preferred stock. The term "preferred stock" means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.
  - (B) Related person. A person shall be treated as related to another person if they bear a relationship to such other person described in section 267(b) or 707(b).
- (4) Regulations. The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection and sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). The Secretary may also prescribe regulations, consistent with the treatment under this subsection and such sections, for the treatment of nonqualified preferred stock under other provisions of this title.

(h) *Cross references.*

- (1) For special rule where another party to the exchange assumes a liability, see section 357.
- (2) For the basis of stock or property received in an exchange to which this section applies, see sections 358 and 362.

(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.
(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61(a)(1).
(5) For coordination of this section with section 304, see section 304(b)(3).

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) *General rule.*
(1) In general. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.
(2) Limitations.
(A) Excess principal amount. Paragraph (1) shall not apply if—
(i) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or
(ii) any such securities are received and no such securities are surrendered.
(B) Property attributable to accrued interest. Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock (including nonqualified preferred stock, as defined in section 351(g)(2)), securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.
(C) Nonqualified preferred stock.
(i) In general. Nonqualified preferred stock (as defined in section 351(g)(2)) received in exchange for stock other than nonqualified preferred stock (as so defined) shall not be treated as stock or securities.
(ii) Recapitalizations of family-owned corporations.
(I) In general. Clause (i) shall not apply in the case of a recapitalization under section 368(a)(1)(E) of a family-owned corporation.
(II) Family-owned corporation. For purposes of this clause, except as provided in regulations, the term "family-owned corporation" means any corporation which is described in clause (i) of section 447(d)(2)(C) throughout the 8-year period beginning on the date which is 5 years before the date of the recapitalization. For purposes of the preceding sentence, stock shall not be treated as owned by a family member during any period described in section 355(d)(6)(B).
(III) Extension of statute of limitations. The statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of 3 years after the date the Secretary is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.
(3) Cross references.
(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including nonqualified preferred stock and property to which paragraph (2)(B) applies), see section 356.
(B) For treatment of accrued interest in the case of an exchange described in paragraph (2)(B), see section 61.

(b) *Exception.*
(1) In general. Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1) unless—
(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and
(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) Cross reference. For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1), see section 355.

(c) *Certain railroad reorganizations.* Notwithstanding any other provision of this subchapter, subsection (a)(1) (and so much of section 356 as relates to this section) shall apply with respect to a plan of reorganization (whether or not a reorganization within the meaning of section 368(a)) for a railroad confirmed under section 1173 of title 11 of the United States Code, as being in the public interest.

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on distributees.*
(1) General rule. If—
(A) a corporation (referred to in this section as the "distributing corporation")—
(i) distributes to a shareholder, with respect to its stock, or
(ii) distributes to a security holder, in exchange for its securities,
solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,
(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),
(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and
(D) as part of the distribution, the distributing corporation distributes—
(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,
then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.
(2) Non pro rata distributions, etc. Paragraph (1) shall be applied without regard to the following:
(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,
(B) whether or not the shareholder surrenders stock in the distributing corporation, and
(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).
(3) Limitations.
(A) Excess principal amount. Paragraph (1) shall not apply if—
(i) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or
(ii) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.
(B) Stock acquired in taxable transactions within 5 years treated as boot. For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction—
(i) which occurs within 5 years of the distribution of such stock, and
(ii) in which gain or loss was recognized in whole or in part,
shall not be treated as stock of such controlled corporation, but as other property.
(C) Property attributable to accrued interest. Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock (including nonqualified preferred stock, as defined in section 351(g)(2)), securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

(D) Nonqualified preferred stock. Nonqualified preferred stock (as defined in section 351(g)(2)) received in a distribution with respect to stock other than nonqualified preferred stock (as so defined) shall not be treated as stock or securities.

(4) Cross references.

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including nonqualified preferred stock and property to which paragraph (3)(C) applies), see section 356.

(B) For treatment of accrued interest in the case of an exchange described in paragraph (3)(C), see section 61.

(b) *Requirements as to active business.*

(1) In general. Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition. For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired by any distributee corporation directly (or through 1 or more corporations, whether through the distributing corporation or otherwise) within the period described in subparagraph (B) and was not acquired by the distributing corporation directly (or through 1 or more corporations) within such period, or

(ii) was so acquired by any such corporation within such period, but, in each case in which such control was so acquired, it was so acquired, only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

For purposes of subparagraph (D), all distributee corporations which are members of the same affiliated group (as defined in section 1504(a) without regard to section 1504(b)) shall be treated as 1 distributee corporation.

(c) *Taxability of corporation on distribution.*

(1) In general. Except as provided in paragraph (2), no gain or loss shall be recognized to a corporation on any distribution to which this section (or so much of section 356 as relates to this section) applies and which is not in pursuance of a plan of reorganization.

(2) Distribution of appreciated property.

(A) In general. If—

(i) in a distribution referred to in paragraph (1), the corporation distributes property other than qualified property, and

(ii) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(B) Qualified property. For purposes of subparagraph (A), the term "qualified property" means any stock or securities in the controlled corporation.

(C) Treatment of liabilities. If any property distributed in the distribution referred to in paragraph (1) is subject to a liability or the shareholder assumes a liability of the

distributing corporation in connection with the distribution, then, for purposes of subparagraph (A), the fair market value of such property shall be treated as not less than the amount of such liability.

(3) Coordination with sections 311 and 336(a). Sections 311 and 336(a) shall not apply to any distribution referred to in paragraph (1).

(d) *Recognition of gain on certain distributions of stock or securities in controlled corporation.*

(1) In general. In the case of a disqualified distribution, any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).

(2) Disqualified distribution. For purposes of this subsection, the term "disqualified distribution" means any distribution to which this section (or so much of section 356 as relates to this section) applies if, immediately after the distribution—

(A) any person holds disqualified stock in the distributing corporation which constitutes a 50-percent or greater interest in such corporation, or

(B) any person holds disqualified stock in the controlled corporation (or, if stock of more than 1 controlled corporation is distributed, in any controlled corporation) which constitutes a 50-percent or greater interest in such corporation.

(3) Disqualified stock. For purposes of this subsection, the term "disqualified stock" means—

(A) any stock in the distributing corporation acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution, and

(B) any stock in any controlled corporation—

(i) acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution, or

(ii) received in the distribution to the extent attributable to distributions on—

(I) stock described in subparagraph (A), or

(II) any securities in the distributing corporation acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution.

(4) 50-percent or greater interest. For purposes of this subsection, the term "50-percent or greater interest" means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.

(5) Purchase. For purposes of this subsection—

(A) In general. Except as otherwise provided in this paragraph, the term "purchase" means any acquisition but only if—

(i) the basis of the property acquired in the hands of the acquirer is not determined (I) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (II) under section 1014(a), and

(ii) the property is not acquired in an exchange to which section 351, 354, 355, or 356 applies.

(B) Certain section 351 exchanges treated as purchases. The term "purchase" includes any acquisition of property in an exchange to which section 351 applies to the extent such property is acquired in exchange for—

(i) any cash or cash item,

(ii) any marketable stock or security, or

(iii) any debt of the transferor.

(C) Carryover basis transactions. If—

(i) any person acquires property from another person who acquired such property by purchase (as determined under this paragraph with regard to this subparagraph), and

(ii) the adjusted basis of such property in the hands of such acquirer is determined in whole or in part by reference to the adjusted basis of such property in the hands of such other person,

such acquirer shall be treated as having acquired such property by purchase on the date it was so acquired by such other person.

(6) Special rule where substantial diminution of risk.

(A) In general. If this paragraph applies to any stock or securities for any period, the running of any 5-year period set forth in subparagraph (A) or (B) of paragraph (3) (whichever applies) shall be suspended during such period.
(B) Property to which suspension applies. This paragraph applies to any stock or securities for any period during which the holder's risk of loss with respect to such stock or securities, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by—
(i) an option,
(ii) a short sale,
(iii) any special class of stock, or
(iv) any other device or transaction.
(7) Aggregation rules.
(A) In general. For purposes of this subsection, a person and all persons related to such person (within the meaning of section 267(b) or 707(b)(1)) shall be treated as one person.
(B) Persons acting pursuant to plans or arrangements. If two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock or securities in the distributing corporation or controlled corporation, such persons shall be treated as one person for purposes of this subsection.
(8) Attribution from entities.
(A) In general. Paragraph (2) of section 318(a) shall apply in determining whether a person holds stock or securities in any corporation (determined by substituting "10 percent" for "50 percent" in subparagraph (C) of such paragraph (2) and by treating any reference to stock as including a reference to securities).
(B) Deemed purchase rule. If—
(i) any person acquires by purchase an interest in any entity, and
(ii) such person is treated under subparagraph (A) as holding any stock or securities by reason of holding such interest,

such stock or securities shall be treated as acquired by purchase by such person on the later of the date of the purchase of the interest in such entity or the date such stock or securities are acquired by purchase by such entity.
(9) Regulations. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including—
(A) regulations to prevent the avoidance of the purposes of this subsection through the use of related persons, intermediaries, pass-thru entities, options, or other arrangements, and
(B) regulations modifying the definition of the term "purchase".

(e) *Recognition of gain on certain distributions of stock or securities in connection with acquisitions.*
(1) General rule. If there is a distribution to which this subsection applies, any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).
(2) Distributions to which subsection applies.
(A) In general. This subsection shall apply to any distribution—
(i) to which this section (or so much of section 356 as relates to this section) applies, and
(ii) which is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.
(B) Plan presumed to exist in certain cases. If 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution, such acquisition shall be treated as pursuant to a plan described in subparagraph (A)(ii) unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.
(C) Certain plans disregarded. A plan (or series of related transactions) shall not be treated as described in subparagraph (A)(ii) if, immediately after the completion of such plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group (as defined in section 1504 without regard to subsection (b) thereof).

(D) Coordination with subsection (d). This subsection shall not apply to any distribution to which subsection (d) applies.

(3) Special rules relating to acquisitions.

(A) Certain acquisitions not taken into account. Except as provided in regulations, the following acquisitions shall not be taken into account in applying paragraph (2)(A)(ii):

(i) The acquisition of stock in any controlled corporation by the distributing corporation.

(ii) The acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation.

(iii) The acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation.

(iv) The acquisition of stock in the distributing corporation or any controlled corporation to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

This subparagraph shall not apply to any acquisition if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) described in paragraph (2)(A)(ii).

(B) Asset acquisitions. Except as provided in regulations, for purposes of this subsection, if the assets of the distributing corporation or any controlled corporation are acquired by a successor corporation in a transaction described in subparagraph (A), (C), or (D) of section 368(a)(1) or any other transaction specified in regulations by the Secretary, the shareholders (immediately before the acquisition) of the corporation acquiring such assets shall be treated as acquiring stock in the corporation from which the assets were acquired.

(4) Definition and special rules. For purposes of this subsection—

(A) 50-percent or greater interest. The term "50-percent or greater interest" has the meaning given such term by subsection (d)(4).

(B) Distributions in title 11 or similar case. Paragraph (1) shall not apply to any distribution made in a title 11 or similar case (as defined in section 368(a)(3)).

(C) Aggregation and attribution rules.

(i) Aggregation. The rules of paragraph (7)(A) of subsection (d) shall apply.

(ii) Attribution. Section 318(a)(2) shall apply in determining whether a person holds stock or securities in any corporation. Except as provided in regulations, section 318(a)(2)(C) shall be applied without regard to the phrase "50 percent or more in value" for purposes of the preceding sentence.

(D) Successors and predecessors. For purposes of this subsection, any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation.

(E) Statute of limitations. If there is a distribution to which paragraph (1) applies—

(i) the statutory period for the assessment of any deficiency attributable to any part of the gain recognized under this subsection by reason of such distribution shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) that such distribution occurred, and

(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(5) Regulations. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations—

(A) providing for the application of this subsection where there is more than 1 controlled corporation,

(B) treating 2 or more distributions as 1 distribution where necessary to prevent the avoidance of such purposes, and

(C) providing for the application of rules similar to the rules of subsection (d)(6) where appropriate for purposes of paragraph (2)(B).

(f) *Section not to apply to certain intragroup distributions.* Except as provided in regulations, this section (or so much of section 356 as relates to this section) shall not apply to the distribution of stock from 1 member of an affiliated group (as defined in section 1504(a)) to another member of such group if such distribution is part of a plan (or series of related transactions) described in subsection (e)(2)(A)(ii) (determined after the application of subsection (e)).

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) *Gain on exchanges.*
   (1) Recognition of gain. If—
      (A) section 354 or 355 would apply to an exchange but for the fact that
      (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

   then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.
   (2) Treatment as dividend. If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) *Additional consideration received in certain distributions.* If—
   (1) section 355 would apply to a distribution but for the fact that
   (2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

(c) *Loss.* If—
   (1) section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that
   (2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,

then no loss from the exchange or distribution shall be recognized.

(d) *Securities as other property.* For purposes of this section—
   (1) In general. Except as provided in paragraph (2), the term "other property" includes securities.
   (2) Exceptions.
      (A) Securities with respect to which nonrecognition of gain would be permitted. The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.
      (B) Greater principal amount in section 354 exchange. If—
         (i) in an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and
         (ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

      then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.
      (C) Greater principal amount in section 355 transaction. If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received, exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term "other property" means only the fair market value of such excess.

(e) *Nonqualified preferred stock treated as other property.* For purposes of this section—
  (1) In general. Except as provided in paragraph (2), the term "other property" includes nonqualified preferred stock (as defined in section 351(g)(2)).
  (2) Exception. The term "other property" does not include nonqualified preferred stock (as so defined) to the extent that, under section 354 or 355, such preferred stock would be permitted to be received without the recognition of gain.

(f) *Exchanges for section 306 stock.* Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as a distribution of property to which section 301 applies.

(g) *Transactions involving gift or compensation.* For special rules for a transaction described in section 354, 355, or this section, but which—
  (1) results in a gift, see section 2501 and following, or
  (2) has the effect of the payment of compensation, see section 61(a)(1).

SEC. 357. ASSUMPTION OF LIABILITY.

(a) *General rule.* Except as provided in subsections (b) and (c), if—
  (1) the taxpayer receives property which would be permitted to be received under section 351 or 361 without the recognition of gain if it were the sole consideration, and
  (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer,

  then such assumption shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351 or 361, as the case may be.

(b) *Tax avoidance purpose.*
  (1) In general. If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a)—
    (A) was a purpose to avoid Federal income tax on the exchange, or
    (B) if not such purpose, was not a bona fide business purpose,

    then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.
  (2) Burden of proof. In any suit or proceeding where the burden is on the taxpayer to prove such assumption is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

(c) *Liabilities in excess of basis.*
  (1) In general. In the case of an exchange—
    (A) to which section 351 applies, or
    (B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

    if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.
  (2) Exceptions. Paragraph (1) shall not apply to any exchange—
    (A) to which subsection (b)(1) of this section applies, or
    (B) which is pursuant to a plan of reorganization within the meaning of section 368(a)(1)(G) where no former shareholder of the transferor corporation receives any consideration for his stock.
  (3) Certain liabilities excluded.
    (A) In general. If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either—
      (i) would give rise to a deduction, or
      (ii) would be described in section 736(a),

      then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed.

(B) Exception. Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

(d) *Determination of amount of liability assumed.*

(1) In general. For purposes of this section, section 358(d), section 358(h), section 362(d), section 368(a)(1)(C), and section 368(a)(2)(B), except as provided in regulations—

(A) a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability; and

(B) except to the extent provided in paragraph (2), a nonrecourse liability shall be treated as having been assumed by the transferee of any asset subject to such liability.

(2) Exception for nonrecourse liability. The amount of the nonrecourse liability treated as described in paragraph (1)(B) shall be reduced by the lesser of—

(A) the amount of such liability which an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to, satisfy; or

(B) the fair market value of such other assets (determined without regard to section 7701(g)).

(3) Regulations. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and section 362(d). The Secretary may also prescribe regulations which provide that the manner in which a liability is treated as assumed under this subsection is applied, where appropriate, elsewhere in this title.

SEC. 358. BASIS TO DISTRIBUTEES.

(a) *General rule.* In the case of an exchange to which section 351, 354, 355, 356, or 361 applies—

(1) Nonrecognition property. The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) Other property. The basis of any other property (except money) received by the taxpayer shall be its fair market value.

(b) *Allocation of basis.*

(1) In general. Under regulations prescribed by the Secretary, the basis determined under subsection (a)(1) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

(2) Special rule for section 355. In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

(c) *Section 355 transactions which are not exchanges.* For purposes of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange.

(d) *Assumption of liability.*

(1) In general. Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

- (2) Exception. Paragraph (1) shall not apply to the amount of any liability excluded under section 357(c)(3).

(e) *Exception.* This section shall not apply to property acquired by a corporation by the exchange of its stock or securities (or the stock or securities of a corporation which is in control of the acquiring corporation) as consideration in whole or in part for the transfer of the property to it.

(f) *Definition of nonrecognition property in case of section 361 exchange.* For purposes of this section, the property permitted to be received under section 361 without the recognition of gain or loss shall be treated as consisting only of stock or securities in another corporation a party to the reorganization.

(g) *Adjustments in intragroup transactions involving section 355.* In the case of a distribution to which section 355 (or so much of section 356 as relates to section 355) applies and which involves the distribution of stock from 1 member of an affiliated group (as defined in section 1504(a) without regard to subsection (b) thereof) to another member of such group, the Secretary may, notwithstanding any other provision of this section, provide adjustments to the adjusted basis of any stock which—

- (1) is in a corporation which is a member of such group, and
- (2) is held by another member of such group, to appropriately reflect the proper treatment of such distribution.

(h) *Special rules for assumption of liabilities to which subsection (d) does not apply.*

- (1) In general. If, after application of the other provisions of this section to an exchange or series of exchanges, the basis of property to which subsection (a)(1) applies exceeds the fair market value of such property, then such basis shall be reduced (but not below such fair market value) by the amount (determined as of the date of the exchange) of any liability—
  - (A) which is assumed by another person as part of the exchange, and
  - (B) with respect to which subsection (d)(1) does not apply to the assumption.
- (2) Exceptions. Except as provided by the Secretary, paragraph (1) shall not apply to any liability if—
  - (A) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or
  - (B) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.
- (3) Liability. For purposes of this subsection, the term "liability" shall include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title.

SEC. 361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS; TREATMENT OF DISTRIBUTIONS.

(a) *General rule.* No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(b) *Exchanges not solely in kind.*

- (1) Gain. If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then—
  - (A) Property distributed. If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but
  - (B) Property not distributed. If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized.

  The amount of gain recognized under subparagraph (B) shall not exceed the sum of the money and the fair market value of the other property so received which is not so distributed.
- (2) Loss. If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(3) Treatment of transfers to creditors. For purposes of paragraph (1), any transfer of the other property or money received in the exchange by the corporation to its creditors in connection with the reorganization shall be treated as a distribution in pursuance of the plan of reorganization. The Secretary may prescribe such regulations as may be necessary to prevent avoidance of tax through abuse of the preceding sentence or subsection (c)(3).

(c) *Treatment of distributions.*

(1) In general. Except as provided in paragraph (2), no gain or loss shall be recognized to a corporation a party to a reorganization on the distribution to its shareholders of property in pursuance of the plan of reorganization.

(2) Distributions of appreciated property.

(A) In general. If—

(i) in a distribution referred to in paragraph (1), the corporation distributes property other than qualified property, and

(ii) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(B) Qualified property. For purposes of this subsection, the term "qualified property" means—

(i) any stock in (or right to acquire stock in) the distributing corporation or obligation of the distributing corporation, or

(ii) any stock in (or right to acquire stock in) another corporation which is a party to the reorganization or obligation of another corporation which is such a party if such stock (or right) or obligation is received by the distributing corporation in the exchange.

(C) Treatment of liabilities. If any property distributed in the distribution referred to in paragraph (1) is subject to a liability or the shareholder assumes a liability of the distributing corporation in connection with the distribution, then, for purposes of subparagraph (A), the fair market value of such property shall be treated as not less than the amount of such liability.

(3) Treatment of certain transfers to creditors. For purposes of this subsection, any transfer of qualified property by the corporation to its creditors in connection with the reorganization shall be treated as a distribution to its shareholders pursuant to the plan of reorganization.

(4) Coordination with other provisions. Section 311 and subpart B of part II of this subchapter shall not apply to any distribution referred to in paragraph (1).

(5) Cross reference. For provision providing for recognition of gain in certain distributions, see section 355(d).

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*

(1) In general. For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization;
(F) a mere change in identity, form, or place of organization of one corporation, however effected; or
(G) a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

(2) Special rules relating to paragraph (1).
(A) Reorganizations described in both paragraph (1)(C) and paragraph (1)(D). If a transaction is described in both paragraph (1)(C), and paragraph (1)(D), then, for purposes of this subchapter (other than for purposes of subparagraph (C)), such transaction shall be treated as described only in paragraph (1)(D).
(B) Additional consideration in certain paragraph (1)(C) cases. If—
(i) one corporation acquires substantially all of the properties of another corporation,
(ii) the acquisition would qualify under paragraph (1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and
(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1)(C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation, then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1)(C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation shall be treated as money paid for the property.
(C) Transfers of assets or stock to subsidiaries in certain paragraph (1)(A), (1)(B), (1)(C), and (1)(G) cases. A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock. A similar rule shall apply to a transaction otherwise qualifying under paragraph (1)(G) where the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met with respect to the acquisition of the assets.
(D) Use of stock of controlling corporation in paragraph (1)(A) and (1)(G) cases. The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as "controlling corporation") which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify a transaction under paragraph (1)(A) or (1)(G) if—
(i) no stock of the acquiring corporation is used in the transaction, and
(ii) in the case of a transaction under paragraph (1)(A), such transaction would have qualified under paragraph (1)(A) had the merger been into the controlling corporation.
(E) Statutory merger using voting stock of corporation controlling merged corporation. A transaction otherwise qualifying under paragraph (1)(A) shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the "controlling corporation") which before the merger was in control of the merged corporation is used in the transaction, if—
(i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and
(ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.
(F) Certain transactions involving 2 or more investment companies.
(i) If immediately before a transaction described in paragraph (1) (other than subparagraph (E) thereof), 2 or more parties to the transaction were investment companies, then the transaction shall not be considered to be a reorganization with respect to any such investment company (and its shareholders and security

holders) unless it was a regulated investment company, a real estate investment trust, or a corporation which meets the requirements of clause (ii).

(ii) A corporation meets the requirements of this clause if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers. For purposes of this clause, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. For purposes of this clause, a person holding stock in a regulated investment company, a real estate investment trust, or an investment company which meets the requirements of this clause shall, except as provided in regulations, be treated as holding its proportionate share of the assets held by such company or trust.

(iii) For purposes of this subparagraph the term "investment company" means a regulated investment company, a real estate investment trust, or a corporation 50 percent or more of the value of whose total assets are stock and securities and 80 percent or more of the value of whose total assets are assets held for investment. In making the 50-percent and 80-percent determinations under the preceding sentence, stock and securities in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and a corporation shall be considered a subsidiary if the parent owns 50 percent or more of the combined voting power of all classes of stock entitled to vote, or 50 percent or more of the total value of shares of all classes of stock outstanding.

(iv) For purposes of this subparagraph, in determining total assets there shall be excluded cash and cash items (including receivables). Government securities, and, under regulations prescribed by the Secretary, assets acquired (through incurring indebtedness or otherwise) for purposes of meeting the requirements of clause (ii) or ceasing to be an investment company.

(v) This subparagraph shall not apply if the stock of each investment company is owned substantially by the same persons in the same proportions.

(vi) If an investment company which does not meet the requirements of clause (ii) acquires assets of another corporation, clause (i) shall be applied to such investment company and its shareholders and security holders as though its assets had been acquired by such other corporation. If such investment company acquires stock of another corporation in a reorganization described in section 368(a)(1)(B), clause (i) shall be applied to the shareholders of such investment company as though they had exchanged with such other corporation all of their stock in such company for stock having a fair market value equal to the fair market value of their stock of such investment company immediately after the exchange. For purposes of section 1001, the deemed acquisition or exchange referred to in the two preceding sentences shall be treated as a sale or exchange of property by the corporation and by the shareholders and security holders to which clause (i) is applied.

(vii) For purposes of clauses (ii) and (iii), the term "securities" includes obligations of State and local governments, commodity futures contracts, shares of regulated investment companies and real estate investment trusts, and other investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36)).

(G) Distribution requirement for paragraph (1)(C).

(i) In general. A transaction shall fail to meet the requirements of paragraph (1)(C) unless the acquired corporation distributes the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization. For purposes of the preceding sentence, if the acquired corporation is liquidated pursuant to the plan of reorganization, any distribution to its creditors in connection with such liquidation shall be treated as pursuant to the plan of reorganization.

(ii) Exception. The Secretary may waive the application of clause (i) to any transaction subject to any conditions the Secretary may prescribe.

(H) Special rules for determining whether certain transactions are qualified under paragraph (1)(d). For purposes of determining whether a transaction qualifies under paragraph (1)(D)—
  (i) in the case of a transaction with respect to which the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, the term "control" has the meaning given such term by section 304(c), and
  (ii) in the case of a transaction with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account.

(3) Additional rules relating to title 11 and similar cases.
  (A) Title 11 or similar case defined. For purposes of this part, the term "title 11 or similar case" means—
    (i) a case under title 11 of the United States Code, or
    (ii) a receivership, foreclosure, or similar proceeding in a Federal or State court.
  (B) Transfer of assets in a title 11 or similar case. In applying paragraph (1)(G), a transfer of the assets of a corporation shall be treated as made in a title 11 or similar case if and only if—
    (i) any party to the reorganization is under the jurisdiction of the court in such case, and
    (ii) the transfer is pursuant to a plan of reorganization approved by the court.
  (C) Reorganizations qualifying under paragraph (1)(G) and another provision. If a transaction would (but for this subparagraph) qualify both—
    (i) under subparagraph (G) of paragraph (1), and
    (ii) under any other subparagraph of paragraph (1) or under section 332 or 351,

  then, for purposes of this subchapter (other than section 357(c)(1)), such transaction shall be treated as qualifying only under subparagraph (G) of paragraph (1).
  (D) Agency receivership proceedings, which involve financial institutions. For purposes of subparagraphs (A) and (B), in the case of a receivership, foreclosure, or similar proceeding before a Federal or State agency involving a financial institution referred to in section 581 or 591, the agency shall be treated as a court.
  (E) Application of paragraph (2)(E)(ii). In the case of a title 11 or similar case, the requirement of clause (ii) of paragraph (2)(E) shall be treated as met if—
    (i) no former shareholder of the surviving corporation received any consideration for his stock, and
    (ii) the former creditors of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, debt of the surviving corporation which had a fair market value equal to 80 percent or more of the total fair market value of the debt of the surviving corporation.

(b) *Party to a reorganization.* For purposes of this part, the term "a party to a reorganization" includes—
  (1) a corporation resulting from a reorganization, and
  (2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1)(B) or (1)(C) of subsection (a), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A), (1)(B), (1)(C), or (1)(G) of subsection (a) by reason of paragraph (2)(C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stock are transferred. In the case of a reorganization qualifying under paragraph (1)(A) or (1)(G) of subsection (a) by reason of paragraph (2)(D) of that subsection, the term "a party to a reorganization" includes the controlling corporation referred to in such paragraph (2)(D). In the case of a reorganization qualifying under subsection (a)(1)(A) by reason of subsection (a)(2)(E), the term "party to a reorganization" includes the controlling corporation referred to in subsection (a)(2)(E).

(c) *Control defined.* For purposes of part I (other than section 304), part II, this part, and part V, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) *General rule.* In the case of the acquisition of assets of a corporation by another corporation—
  (1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies; or
  (2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1), the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c). For purposes of the preceding sentence, a reorganization shall be treated as meeting the requirements of subparagraph (D) or (G) of section 368(a)(1) only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met.

(b) *Operating rules.* Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—
  (1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.
  (2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.
  (3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

(c) *Items of the distributor or transferor corporation.* The items referred to in subsection (a) are:
  (1) Net operating loss carryovers. The net operating loss carryovers determined under section 172, subject to the following conditions and limitations:
    (A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer.
    (B) In determining the net operating loss deduction, the portion of such deduction attributable to the net operating loss carryovers of the distributor or transferor corporation to the first taxable year of the acquiring corporation ending after the date of distribution or transfer shall be limited to an amount which bears the same ratio to the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.
    (C) For the purpose of determining the amount of the net operating loss carryovers under section 172(b)(2), a net operating loss for a taxable year (hereinafter in this subparagraph referred to as the "loss year") of a distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. For the same purpose, the taxable income for a "prior taxable year" (as the term is used in section 172(b)(2)) shall be computed as provided in such section; except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation—
      (i) such taxable year shall (for the purpose of this subparagraph only) be considered to be 2 taxable years (hereinafter in this subparagraph referred to as the "pre-acquisition part year" and the "post-acquisition part year");
      (ii) the pre-acquisition part year shall begin on the same day as such taxable year begins and shall end on the date of distribution or transfer;

(iii) the post-acquisition part year shall begin on the day following the date of distribution or transfer and shall end on the same day as the end of such taxable year;
(iv) the taxable income for such taxable year (computed with the modifications specified in section 172(b)(2)(A) but without a net operating loss deduction) shall be divided between the pre-acquisition part year and the post-acquisition part year in proportion to the number of days in each;
(v) the net operating loss deduction for the pre-acquisition part year shall be determined as provided in section 172(b)(2)(B), but without regard to a net operating loss year of the distributor or transferor corporation; and
(vi) the net operating loss deduction for the post-acquisition part year shall be determined as provided in section 172(b)(2)(B).

(2) Earnings and profits. In the case of a distribution or transfer described in subsection (a)—
(A) the earnings and profits or deficit in earnings and profits, as the case may be, of the distributor or transferor corporation shall, subject to subparagraph (B), be deemed to have been received or incurred by the acquiring corporation as of the close of the date of the distribution or transfer; and
(B) a deficit in earnings and profits of the distributor, transferor, or acquiring corporation shall be used only to offset earnings and profits accumulated after the date of transfer. For this purpose, the earnings and profits for the taxable year of the acquiring corporation in which the distribution or transfer occurs shall be deemed to have been accumulated after such distribution or transfer in an amount which bears the same ratio to the undistributed earnings and profits of the acquiring corporation for such taxable year (computed without regard to any earnings and profits received from the distributor or transferor corporation, as described in subparagraph (A) of this paragraph) as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.

(3) Capital loss carryover. The capital loss carryover determined under section 1212, subject to the following conditions and limitations:
(A) The taxable year of the acquiring corporation to which the capital loss carryover of the distributor or transferor corporation is first carried shall be the first taxable year ending after the date of distribution or transfer.
(B) The capital loss carryover shall be a short-term capital loss in the taxable year determined under subparagraph (A) but shall be limited to an amount which bears the same ratio to the capital gain net income (determined without regard to a short-term capital loss attributable to capital loss carryover), if any, of the acquiring corporation in such taxable year as the number of days in the taxable year after the date of distribution or transfer bears to the total number of days in the taxable year.
(C) For purposes of determining the amount of such capital loss carryover to taxable years following the taxable year determined under subparagraph (A), the capital gain net income in the taxable year determined under subparagraph (A) shall be considered to be an amount equal to the amount determined under subparagraph (B).

(4) Method of accounting. The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

(5) Inventories. In any case in which inventories are received by the acquiring corporation, such inventories shall be taken by such corporation (in determining its income) on the same basis on which such inventories were taken by the distributor or transferor corporation, unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of taking inventory adopted pursuant to regulations prescribed by the Secretary.

(6) Method of computing depreciation allowance. The acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the depreciation allowance under sections 167 and 168 on property acquired in a distribution or transfer with respect to so much of the basis in the hands of the acquiring corporation as does not exceed the adjusted basis in the hands of the distributor or transferor corporation.

(7) Repealed.
(8) Installment method. If the acquiring corporation acquires installment obligations (the income from which the distributor or transferor corporation reports on the installment basis under section 453) the acquiring corporation shall, for purposes of section 453, be treated as if it were the distributor or transferor corporation.
(9) Amortization of bond discount or premium. If the acquiring corporation assumes liability for bonds of the distributor or transferor corporation issued at a discount or premium, the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable or includible with respect to such discount or premium.
(10) Treatment of certain mining development and exploration expenses of distributor or transferor corporation. The acquiring corporation shall be entitled to deduct, as if it were the distributor or transferor corporation, expenses deferred under section 616 (relating to certain development expenditures) if the distributor or transferor corporation has so elected.
(11) Contributions to pension plans, employees' annuity plans, and stock bonus and profit-sharing plans. The acquiring corporation shall be considered to be the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the amounts deductible under section 404 with respect to pension plans, employees' annuity plans, and stock bonus and profit-sharing plans.
(12) Recovery of tax benefit items. If the acquiring corporation is entitled to the recovery of any amounts previously deducted by (or allowable as credits to) the distributor or transferor corporation, the acquiring corporation shall succeed to the treatment under section 111 which would apply to such amounts in the hands of the distributor or transferor corporation.
(13) Involuntary conversions under section 1033. The acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of applying section 1033.
(14) Dividend carryover to personal holding company. The dividend carryover (described in section 564) to taxable years ending after the date of distribution or transfer.
(15) Repealed.
(16) Certain obligations of distributor or transferor corporation. If the acquiring corporation—
  (A) assumes an obligation of the distributor or transferor corporation which, after the date of the distribution or transfer, gives rise to a liability, and
  (B) such liability, if paid or accrued by the distributor or transferor corporation, would have been deductible in computing its taxable income, the acquiring corporation shall be entitled to deduct such items when paid or accrued, as the case may be, as if such corporation were the distributor or transferor corporation. A corporation which would have been an acquiring corporation under this section if the date of distribution or transfer had occurred on or after the effective date of the provisions of this subchapter applicable to a liquidation or reorganization, as the case may be, shall be entitled, even though the date of distribution or transfer occurred before such effective date, to apply this paragraph with respect to amounts paid or accrued in taxable years beginning after December 31, 1953, on account of such obligations of the distributor or transferor corporation. This paragraph shall not apply if such obligations are reflected in the amount of stock, securities, or property transferred by the acquiring corporation to the transferor corporation for the property of the transferor corporation.
(17) Deficiency dividend of personal holding company. If the acquiring corporation pays a deficiency dividend (as defined in section 547(d)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 547.
(18) Percentage depletion on extraction of ores or minerals from the waste or residue of prior mining. The acquiring corporation shall be considered to be the distributor or transferor corporation for the purpose of determining the applicability of section 613(c)(3) (relating to extraction of ores or minerals from the ground).
(19) Charitable contributions in excess of prior years' limitations. Contributions made in the taxable year ending on the date of distribution or transfer and the 4 prior taxable years by the distributor or transferor corporation in excess of the amount deductible under section 170(b)(2) for such taxable years shall be deductible by the acquiring corporation for its taxable years which begin after the date of distribution or transfer, subject to the limitations imposed in section 170(b)(2). In applying the preceding sentence, each taxable year of the

distributor or transferor corporation beginning on or before the date of distribution or transfer shall be treated as a prior taxable year with reference to the acquiring corporation's taxable years beginning after such date.

(20), (21) Repealed.

(22) Successor insurance company. If the acquiring corporation is an insurance company taxable under subchapter L, there shall be taken into account (to the extent proper to carry out the purposes of this section and of subchapter L, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of subchapter L in respect of the distributor or transferor corporation.

(23) Deficiency dividend of regulated investment company or real estate investment trust. If the acquiring corporation pays a deficiency dividend (as defined in section 860(f)) with respect to the distributor or transferor corporation, such distributor or transferor corporation shall, with respect to such payments, be entitled to the deficiency dividend deduction provided in section 860.

(24) Credit under section 38. The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation.

(25) Credit under section 53. The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 53, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 53 in respect of the distributor or transferor corporation.

(26) Enterprise zone provisions. The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and subchapter U, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of subchapter U in respect of the distributor or transferor corporation.

(d) *Operations loss carrybacks and carryovers of life insurance companies.* For application of this part to operations loss carrybacks and carryovers of life insurance companies, see section 810.

SEC. 382. LIMITATION ON NET OPERATING LOSS CARRYFORWARDS AND CERTAIN BUILT-IN LOSSES FOLLOWING OWNERSHIP CHANGE.

(a) *General rule.* The amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the section 382 limitation for such year.

(b) *Section 382 limitation.* For purposes of this section—

(1) In general. Except as otherwise provided in this section, the section 382 limitation for any post-change year is an amount equal to—

(A) the value of the old loss corporation, multiplied by

(B) the long-term tax-exempt rate.

(2) Carryforward of unused limitation. If the section 382 limitation for any post-change year exceeds the taxable income of the new loss corporation for such year which was offset by pre-change losses, the section 382 limitation for the next post-change year shall be increased by the amount of such excess.

(3) Special rule for post-change year which includes change date. In the case of any post-change year which includes the change date—

(A) Limitation does not apply to taxable income before change. Subsection (a) shall not apply to the portion of the taxable income for such year which is allocable to the period in such year on or before the change date. Except as provided in subsection (h)(5) and in regulations, taxable income shall be allocated ratably to each day in the year.

(B) Limitation for period after change. For purposes of applying the limitation of subsection (a) to the remainder of the taxable income for such year, the section 382 limitation shall be an amount which bears the same ratio to such limitation (determined without regard to this paragraph) as—

(i) the number of days in such year after the change date, bears to

(ii) the total number of days in such year.

(c) *Carryforwards disallowed if continuity of business requirements not met.*
  (1) In general. Except as provided in paragraph (2), if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero.
  (2) Exception for certain gains. The section 382 limitation for any post-change year shall not be less than the sum of—
    (A) any increase in such limitation under—
      (i) subsection (h)(1)(A) for recognized built-in gains for such year, and
      (ii) subsection (h)(1)(C) for gain recognized by reason of an election under section 338, plus
    (B) any increase in such limitation under subsection (b)(2) for amounts described in subparagraph (A) which are carried forward to such year.

(d) *Pre-change loss and post-change year.* For purposes of this section—
  (1) Pre-change loss. The term "pre-change loss" means—
    (A) any net operating loss carryforward of the old loss corporation to the taxable year ending with the ownership change or in which the change date occurs, and
    (B) the net operating loss of the old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable to the period in such year on or before the change date.

  Except as provided in subsection (h)(5) and in regulations, the net operating loss shall, for purposes of subparagraph (B), be allocated ratably to each day in the year.
  (2) Post-change year. The term "post-change year" means any taxable year ending after the change date.

(e) *Value of old loss corporation.* For purposes of this section—
  (1) In general. Except as otherwise provided in this subsection, the value of the old loss corporation is the value of the stock of such corporation (including any stock described in section 1504(a)(4)) immediately before the ownership change.
  (2) Special rule in the case of redemption or other corporate contraction. If a redemption or other corporate contraction occurs in connection with an ownership change, the value under paragraph (1) shall be determined after taking such redemption or other corporate contraction into account.
  (3) Treatment of foreign corporations. Except as otherwise provided in regulations, in determining the value of any old loss corporation which is a foreign corporation, there shall be taken into account only items treated as connected with the conduct of a trade or business in the United States.

(f) *Long-term tax-exempt rate.* For purposes of this section—
  (1) In general. The long-term tax-exempt rate shall be the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs.
  (2) Adjusted Federal long-term rate. For purposes of paragraph (1), the term "adjusted Federal long-term rate" means the Federal long-term rate determined under section 1274(d), except that—
    (A) paragraphs (2) and (3) thereof shall not apply, and
    (B) such rate shall be properly adjusted for differences between rates on long-term taxable and tax-exempt obligations.

(g) *Ownership change.* For purposes of this section—
  (1) In general. There is an ownership change if, immediately after any owner shift involving a 5-percent shareholder or any equity structure shift—
    (A) the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over
    (B) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.
  (2) Owner shift involving 5-percent shareholder. There is an owner shift involving a 5-percent shareholder if—
    (A) there is any change in the respective ownership of stock of a corporation, and
    (B) such change affects the percentage of stock of such corporation owned by any person who is a 5-percent shareholder before or after such change.

(3) Equity structure shift defined.

(A) In general. The term "equity structure shift" means any reorganization (within the meaning of section 368). Such term shall not include—

(i) any reorganization described in subparagraph (D) or (G) of section 368(a)(1) unless the requirements of section 354(b)(1) are met, and

(ii) any reorganization described in subparagraph (F) of section 368(a)(1).

(B) Taxable reorganization-type transactions, etc. To the extent provided in regulations, the term "equity structure shift" includes taxable reorganization-type transactions, public offerings, and similar transactions.

(4) Special rules for application of subsection.

(A) Treatment of less than 5-percent shareholders. Except as provided in subparagraphs (B)(i) and (C), in determining whether an ownership change has occurred, all stock owned by shareholders of a corporation who are not 5-percent shareholders of such corporation shall be treated as stock owned by 1 5-percent shareholder of such corporation.

(B) Coordination with equity structure shifts. For purposes of determining whether an equity structure shift (or subsequent transaction) is an ownership change—

(i) Less than 5-percent shareholders. Subparagraph (A) shall be applied separately with respect to each group of shareholders (immediately before such equity structure shift) of each corporation which was a party to the reorganization involved in such equity structure shift.

(ii) Acquisitions of stock. Unless a different proportion is established, acquisitions of stock after such equity structure shift shall be treated as being made proportionately from all shareholders immediately before such acquisition.

(C) Coordination with other owner shifts. Except as provided in regulations, rules similar to the rules of subparagraph (B) shall apply in determining whether there has been an owner shift involving a 5-percent shareholder and whether such shift (or subsequent transaction) results in an ownership change.

(D) Treatment of worthless stock. If any stock held by a 50-percent shareholder is treated by such shareholder as becoming worthless during any taxable year of such shareholder and such stock is held by such shareholder as of the close of such taxable year, for purposes of determining whether an ownership change occurs after the close of such taxable year, such shareholder—

(i) shall be treated as having acquired such stock on the 1st day of his 1st succeeding taxable year, and

(ii) shall not be treated as having owned such stock during any prior period.

For purposes of the preceding sentence, the term 50-percent shareholder means any person owning 50 percent or more of the stock of the corporation at any time during the 3-year period ending on the last day of the taxable year with respect to which the stock was so treated.

(h) *Special rules for built-in gains and losses and section 338 gains.* For purposes of this section—

(1) In general.

(A) Net unrealized built-in gain.

(i) In general. If the old loss corporation has a net unrealized built-in gain, the section 382 limitation for any recognition period taxable year shall be increased by the recognized built-in gains for such taxable year.

(ii) Limitation. The increase under clause (i) for any recognition period taxable year shall not exceed—

(I) the net unrealized built-in gain, reduced by

(II) recognized built-in gains for prior years ending in the recognition period.

(B) Net unrealized built-in loss.

(i) In general. If the old loss corporation has a net unrealized built-in loss, the recognized built-in loss for any recognition period taxable year shall be subject to limitation under this section in the same manner as if such loss were a pre-change loss.

(ii) Limitation. Clause (i) shall apply to recognized built-in losses for any recognition period taxable year only to the extent such losses do not exceed—

(I) the net unrealized built-in loss, reduced by

(II) recognized built-in losses for prior taxable years ending in the recognition period.

(C) Special rules for certain section 338 gains. If an election under section 338 is made in connection with an ownership change and the net unrealized built-in gain is zero by reason of paragraph (3)(B), then, with respect to such change, the section 382 limitation for the post-change year in which gain is recognized by reason of such election shall be increased by the lesser of—

(i) the recognized built-in gains by reason of such election, or

(ii) the net unrealized built-in gain (determined without regard to paragraph (3)(B)).

(2) Recognized built-in gain and loss.

(A) Recognized built-in gain. The term "recognized built-in gain" means any gain recognized during the recognition period on the disposition of any asset to the extent the new loss corporation establishes that—

(i) such asset was held by the old loss corporation immediately before the change date, and

(ii) such gain does not exceed the excess of—

(I) the fair market value of such asset on the change date, over

(II) the adjusted basis of such asset on such date.

(B) Recognized built-in loss. The term "recognized built-in loss" means any loss recognized during the recognition period on the disposition of any asset except to the extent the new loss corporation establishes that—

(i) such asset was not held by the old loss corporation immediately before the change date, or

(ii) such loss exceeds the excess of—

(I) the adjusted basis of such asset on the change date, over

(II) the fair market value of such asset on such date.

Such term includes any amount allowable as depreciation, amortization, or depletion for any period within the recognition period except to the extent the new loss corporation establishes that the amount so allowable is not attributable to the excess described in clause (ii).

(3) Net unrealized built-in gain and loss defined.

(A) Net unrealized built-in gain and loss.

(i) In general. The terms "net unrealized built-in gain" and "net unrealized built-in loss" mean, with respect to any old loss corporation, the amount by which—

(I) the fair market value of the assets of such corporation immediately before an ownership change is more or less, respectively, than

(II) the aggregate adjusted basis of such assets at such time.

(ii) Special rule for redemptions or other corporate contractions. If a redemption or other corporate contraction occurs in connection with an ownership change, to the extent provided in regulations, determinations under clause (i) shall be made after taking such redemption or other corporate contraction into account.

(B) Threshold requirement.

(i) In general. If the amount of the net unrealized built-in gain or net unrealized built-in loss (determined without regard to this subparagraph) of any old loss corporation is not greater than the lesser of—

(I) 15 percent of the amount determined for purposes of subparagraph (A)(i)(I), or

(II) $10,000,000,

the net unrealized built-in gain or net unrealized built-in loss shall be zero.

(ii) Cash and cash items not taken into account. In computing any net unrealized built-in gain or net unrealized built-in loss under clause (i), except as provided in regulations, there shall not be taken into account—

(I) any cash or cash item, or

(II) any marketable security which has a value which does not substantially differ from adjusted basis.

(4) Disallowed loss allowed as a carryforward. If a deduction for any portion of a recognized built-in loss is disallowed for any post-change year, such portion—

(A) shall be carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of net operating losses (or to the extent the amount so

disallowed is attributable to capital losses, under rules similar to the rules for the carrying forward of net capital losses), but

(B) shall be subject to limitation under this section in the same manner as a pre-change loss.

(5) Special rules for post-change year which includes change date. For purposes of subsection (b)(3)—

(A) in applying subparagraph (A) thereof, taxable income shall be computed without regard to recognized built-in gains to the extent such gains increased the section 382 limitation for the year (or recognized built-in losses to the extent such losses are treated as pre-change losses), and gain described in paragraph (1)(C), for the year, and

(B) in applying subparagraph (B) thereof, the section 382 limitation shall be computed without regard to recognized built-in gains, and gain described in paragraph (1)(C), for the year.

(6) Treatment of certain built-in items.

(A) Income items. Any item of income which is properly taken into account during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account.

(B) Deduction items. Any amount which is allowable as a deduction during the recognition period (determined without regard to any carryover) but which is attributable to periods before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction.

(C) Adjustments. The amount of the net unrealized built-in gain or loss shall be properly adjusted for amounts which would be treated as recognized built-in gains or losses under this paragraph if such amounts were properly taken into account (or allowable as a deduction) during the recognition period.

(7) Recognition period, etc.

(A) Recognition period. The term "recognition period" means, with respect to any ownership change, the 5-year period beginning on the change date.

(B) Recognition period taxable year. The term "recognition period taxable year" means any taxable year any portion of which is in the recognition period.

(8) Determination of fair market value in certain cases. If 80 percent or more in value of the stock of a corporation is acquired in 1 transaction (or in a series of related transactions during any 12-month period), for purposes of determining the net unrealized built-in loss, the fair market value of the assets of such corporation shall not exceed the grossed up amount paid for such stock properly adjusted for indebtedness of the corporation and other relevant items.

(9) Tax-free exchanges or transfers. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection where property held on the change date was acquired (or is subsequently transferred) in a transaction where gain or loss is not recognized (in whole or in part).

(i) *Testing period.* For purposes of this section—

(1) 3-year period. Except as otherwise provided in this section, the testing period is the 3-year period ending on the day of any owner shift involving a 5-percent shareholder or equity structure shift.

(2) Shorter period where there has been recent ownership change. If there has been an ownership change under this section, the testing period for determining whether a 2nd ownership change has occurred shall not begin before the 1st day following the change date for such earlier ownership change.

(3) Shorter period where all losses arise after 3-year period begins. The testing period shall not begin before the earlier of the 1st day of the 1st taxable year from which there is a carryforward of a loss or of an excess credit to the 1st post-change year or the taxable year in which the transaction being tested occurs. Except as provided in regulations, this paragraph shall not apply to any loss corporation, which has a net unrealized built-in loss (determined after application of subsection (h)(3)(B)).

(j) *Change date*. For purposes of this section, the change date is—

(1) in the case where the last component of an ownership change is an owner shift involving a 5-percent shareholder, the date on which such shift occurs, and

(2) in the case where the last component of an ownership change is an equity structure shift, the date of the reorganization.

(k) *Definitions and special rules*. For purposes of this section—

(1) Loss corporation. The term "loss corporation" means a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. Except to the extent provided in regulations, such term includes any corporation with a net unrealized built-in loss.

(2) Old loss corporation. The term "old loss corporation" means any corporation—

(A) with respect to which there is an ownership change, and

(B) which (before the ownership change) was a loss corporation.

(3) New loss corporation. The term "new loss corporation" means a corporation which (after an ownership change) is a loss corporation. Nothing in this section shall be treated as implying that the same corporation may not be both the old loss corporation and the new loss corporation.

(4) Taxable income. Taxable income shall be computed with the modifications set forth in section 172(d).

(5) Value. The term "value" means fair market value.

(6) Rules relating to stock.

(A) Preferred stock. Except as provided in regulations and subsection (e), the term "stock" means stock other than stock described in section 1504(a)(4).

(B) Treatment of certain rights, etc. The Secretary shall prescribe such regulations as may be necessary—

(i) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and

(ii) to treat stock as not stock.

(C) Determinations on basis of value. Determinations of the percentage of stock of any corporation held by any person shall be made on the basis of value.

(7) 5-percent shareholder. The term "5-percent shareholder" means any person holding 5 percent or more of the stock of the corporation at any time during the testing period.

(l) *Certain additional operating rules*. For purposes of this section—

(1) Certain capital contributions not taken into account.

(A) In general. Any capital contribution received by an old loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under this section shall not be taken into account for purposes of this section.

(B) Certain contributions treated as part of plan. For purposes of subparagraph (A), any capital contribution made during the 2-year period ending on the change date shall, except as provided in regulations, be treated as part of a plan described in subparagraph (A).

(2) Ordering rules for application of section.

(A) Coordination with section 172(b) carryover rules. In the case of any pre-change loss for any taxable year (hereinafter in this subparagraph referred to as the "loss year") subject to limitation under this section, for purposes of determining under the 2nd sentence of section 172(b)(2) the amount of such loss which may be carried to any taxable year, taxable income for any taxable year shall be treated as not greater than—

(i) the section 382 limitation for such taxable year, reduced by

(ii) the unused pre-change losses for taxable years preceding the loss year.

Similar rules shall apply in the case of any credit or loss subject to limitation under section 383.

(B) Ordering rule for losses carried from same taxable year. In any case in which—

(i) a pre-change loss of a loss corporation for any taxable year is subject to a section 382 limitation, and

(ii) a net operating loss of such corporation from such taxable year is not subject to such limitation, taxable income shall be treated as having been offset first by the loss subject to such limitation.

(3) Operating rules relating to ownership of stock.

(A) Constructive ownership. Section 318 (relating to constructive ownership of stock) shall apply in determining ownership of stock, except that—

(i) paragraphs (1) and (5)(B) of section 318(a) shall not apply and an individual and all members of his family described in paragraph (1) of section 318(a) shall be treated as 1 individual for purposes of applying this section,

(ii) paragraph (2) of section 318(a) shall be applied—

(I) without regard to the 50-percent limitation contained in subparagraph (C) thereof, and

(II) except as provided in regulations, by treating stock attributed thereunder as no longer being held by the entity from which attributed,

(iii) paragraph (3) of section 318(a) shall be applied only to the extent provided in regulations,

(iv) except to the extent provided in regulations, an option to acquire stock shall be treated as exercised if such exercise results in an ownership change, and

(v) in attributing stock from an entity under paragraph (2) of section 318(a), there shall not be taken into account—

(I) in the case of attribution from a corporation, stock which is not treated as stock for purposes of this section, or

(II) in the case of attribution from another entity, an interest in such entity similar to stock described in subclause (I).

A rule similar to the rule of clause (iv) shall apply in the case of any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interests.

(B) Stock acquired by reason of death, gift, divorce, separation, etc. If—

(i) the basis of any stock in the hands of any person is determined—

(I) under section 1014 (relating to property acquired from a decedent),

(II) section 1015 (relating to property acquired by a gift or transfer in trust), or

(III) section 1041(b)(2) (relating to transfers of property between spouses or incident to divorce),

(ii) stock is received by any person in satisfaction of a right to receive a pecuniary bequest, or

(iii) stock is acquired by a person pursuant to any divorce or separation instrument (within the meaning of section 71(b)(2)),

such person shall be treated as owning such stock during the period such stock was owned by the person from whom it was acquired.

(C) Certain changes in percentage ownership which are attributable to fluctuations in value not taken into account. Except as provided in regulations, any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account.

(4) Reduction in value where substantial nonbusiness assets.

(A) In general. If, immediately after an ownership change, the new loss corporation has substantial nonbusiness assets, the value of the old loss corporation shall be reduced by the excess (if any) of—

(i) the fair market value of the nonbusiness assets of the old loss corporation, over

(ii) the nonbusiness asset share of indebtedness for which such corporation is liable.

(B) Corporation having substantial nonbusiness assets. For purposes of subparagraph (A)—

(i) In general. The old loss corporation shall be treated as having substantial nonbusiness assets if at least 1/3 of the value of the total assets of such corporation consists of nonbusiness assets.

(ii) Exception for certain investment entities. A regulated investment company to which part I of subchapter M applies, a real estate investment trust to which part II of subchapter M applies, a REMIC to which part IV of subchapter M applies, or a FASIT to which part V of subchapter M applies, shall not be treated as a new loss corporation having substantial nonbusiness assets.

(C) Nonbusiness assets. For purposes of this paragraph, the term "nonbusiness assets" means assets held for investment.

(D) Nonbusiness asset share. For purposes of this paragraph, the nonbusiness asset share of the indebtedness of the corporation is an amount, which bears the same ratio to such indebtedness as—

(i) the fair market value of the nonbusiness assets of the corporation, bears to

(ii) the fair market value of all assets of such corporation.

(E) Treatment of subsidiaries. For purposes of this paragraph, stock and securities in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets. For purposes of the preceding sentence, a corporation shall be treated as a subsidiary if the parent owns 50 percent or more of the combined voting power of all classes of stock entitled to vote, and 50 percent or more of the total value of shares of all classes of stock.

(5) Title 11 or similar case.

(A) In general. Subsection (a) shall not apply to any ownership change if—

(i) the old loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a title 11 or similar case, and

(ii) the shareholders and creditors of the old loss corporation (determined immediately before such ownership change) own (after such ownership change and as a result of being shareholders or creditors immediately before such change) stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy) which meets the requirements of section 1504(a)(2) (determined by substituting "50 percent" for "80 percent" each place it appears).

(B) Reduction for interest payments to creditors becoming shareholders. In any case to which subparagraph (A) applies, the pre-change losses and excess credits (within the meaning of section 383(a)(2)) which may be carried to a post-change year shall be computed as if no deduction was allowable under this chapter for the interest paid or accrued by the old loss corporation on indebtedness which was converted into stock pursuant to title 11 or similar case during—

(i) any taxable year ending during the 3-year period preceding the taxable year in which the ownership change occurs, and

(ii) the period of the taxable year in which the ownership change occurs on or before the change date.

(C) Coordination with section 108. In applying section 108(e)(8) to any case to which subparagraph (A) applies, there shall not be taken into account any indebtedness for interest described in subparagraph (B).

(D) Section 382 limitation zero if another change within 2 years. If, during the 2-year period immediately following an ownership change to which this paragraph applies, an ownership change of the new loss corporation occurs, this paragraph shall not apply and the section 382 limitation with respect to the 2nd ownership change for any post-change year ending after the change date of the 2nd ownership change shall be zero.

(E) Only certain stock taken into account. For purposes of subparagraph (A)(ii), stock transferred to a creditor shall be taken into account only to the extent such stock is transferred in satisfaction of indebtedness and only if such indebtedness—

(i) was held by the creditor at least 18 months before the date of the filing of the title 11 or similar case, or

(ii) arose in the ordinary course of the trade or business of the old loss corporation and is held by the person who at all times held the beneficial interest in such indebtedness.

(F) Special rule for certain financial institutions.

(i) In general. In the case of any ownership change to which this subparagraph applies, this paragraph shall be applied—

(I) by substituting "1504(a)(2)(B)" for "1504(a)(2)" and "20 percent" for "50 percent" in subparagraph (A)(ii), and

(II) without regard to subparagraphs (B) and (C).

(ii) Special rule for depositors. For purposes of applying this paragraph to an ownership change to which this subparagraph applies—

(I) a depositor in the old loss corporation shall be treated as a stockholder in such loss corporation immediately before the change,

(II) deposits which, after the change, become deposits of the new loss corporation shall be treated as stock of the new loss corporation, and

(III) the fair market value of the outstanding stock of the new loss corporation shall include the amount of deposits in the new loss corporation immediately after the change.

(iii) Changes to which subparagraph applies. This subparagraph shall apply to—

(I) an equity structure shift which is a reorganization described in section 368(a)(3)(D)(ii) (as modified by section 368(a)(3)(D)(iv)), or

(II) any other equity structure shift (or transaction to which section 351 applies) which occurs as an integral part of a transaction involving a change to which subclause (I) applies.

This subparagraph shall not apply to any equity structure shift or transaction occurring on or after May 10, 1989.

(G) Title 11 or similar case. For purposes of this paragraph, the term "title 11 or similar case" has the meaning given such term by section 368(a)(3)(A).

(H) Election not to have paragraph apply. A new loss corporation may elect, subject to such terms and conditions as the Secretary may prescribe, not to have the provisions of this paragraph apply.

(6) Special rule for insolvency transactions. If paragraph (5) does not apply to any reorganization described in subparagraph (G) of section 368(a)(1) or any exchange of debt for stock in a title 11 or similar case (as defined in section 368(a)(3)(A)), the value under subsection (e) shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.

(7) Coordination with alternative minimum tax. The Secretary shall by regulation provide for the application of this section to the alternative tax net operating loss deduction under section 56(d).

(8) Predecessor and successor entities. Except as provided in regulations, any entity and any predecessor or successor entities of such entity shall be treated as 1 entity.

(m) *Regulations*. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section and section 383, including (but not limited to) regulations—

(1) providing for the application of this section and section 383 where an ownership change with respect to the old loss corporation is followed by an ownership change with respect to the new loss corporation, and

(2) providing for the application of this section and section 383 in the case of a short taxable year,

(3) providing for such adjustments to the application of this section and section 383 as is necessary to prevent the avoidance of the purposes of this section and section 383, including the avoidance of such purposes through the use of related persons, pass-thru entities, or other intermediaries,

(4) providing for the application of subsection (g)(4) where there is only 1 corporation involved, and

(5) providing, in the case of any group of corporations described in section 1563(a) (determined by substituting "50 percent" for "80 percent" each place it appears and determined without regard to paragraph (4) thereof), appropriate adjustments to value, built-in gain or loss, and other items so that items are not omitted or taken into account more than once.

SEC. 383. SPECIAL LIMITATIONS ON CERTAIN EXCESS CREDITS, ETC.

(a) *Excess Credits.*

(1) In general. Under regulations, if an ownership change occurs with respect to a corporation, the amount of any excess credit for any taxable year which may be used in any post-change year shall be limited to an amount determined on the basis of the tax liability which is attributable to so much of the taxable income as does not exceed the section 382 limitation for such post-change year to the extent available after the application of section 382 and subsections (b) and (c) of this section.

(2) Excess credit. For purposes of paragraph (1), the term "excess credit" means

(A) any unused general business credit of the corporation under section 39, and

(B) any unused minimum tax credit of the corporation under section 53.

(b) *Limitation On Net Capital Loss.* If an ownership change occurs with respect to a corporation, the amount of any net capital loss under section 1212 for any taxable year before the 1st post-change year, which may be used in any post-change year shall be limited under regulations which shall be based on the principles applicable under section 382. Such regulations shall provide that any such net capital loss used in a post-change year shall reduce the section 382 limitation which is applied to pre-change losses under section 382 for such year.

(c) *Foreign Tax Credits.* If an ownership change occurs with respect to a corporation, the amount of any excess foreign taxes under section 904(c) for any taxable year before the 1st post-change taxable year shall be limited under regulations, which shall be consistent with purposes of this section and section 382.

(d) *Pro Ration Rules For Year Which Includes Change.* For purposes of this section, rules similar to the rules of subsections (b)(3) and (d)(1)(B) of section 382 shall apply.

(e) *Definitions.* Terms used in this section shall have the same respective meanings as when used in section 382, except that appropriate adjustments shall be made to take into account that the limitations of this section apply to credits and net capital losses.

SEC. 384. LIMITATION ON USE OF PREACQUISITION LOSSES TO OFFSET BUILT-IN GAINS.

(a) *General Rule.* If
  (1) (A) a corporation acquires directly (or through 1 or more other corporations) control of another corporation, or
    (B) the assets of a corporation are acquired by another corporation in a reorganization described in subparagraph (A), (C), or (D) of section 368(a)(1), and
  (2) either of such corporations is a gain corporation, income for any recognition period taxable year (to the extent attributable to recognized built-in gains) shall not be offset by any preacquisition loss (other than a preacquisition loss of the gain corporation).

(b) *Exception Where Corporations Under Common Control.*
  (1) In general. Subsection (a) shall not apply to the preacquisition loss of any corporation if such corporation and the gain corporation were members of the same controlled group at all times during the 5-year period ending on the acquisition date.
  (2) Controlled group. For purposes of this subsection, the term "controlled group" means a controlled group of corporations (as defined in section 1563(a)) except that
    (A) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears,
    (B) the ownership requirements of section 1563(a) must be met both with respect to voting power and value, and
    (C) the determination shall be made without regard to subsection (a)(4) of section 1563.
  (3) Shorter period where corporations not in existence for 5 years. If either of the corporations referred to in paragraph (1) was not in existence throughout the 5-year period referred to in paragraph (1), the period during which such corporation was in existence (or if both, the shorter of such periods) shall be substituted for such 5-year period.

(c) *Definitions.* For purposes of this section
  (1) Recognized built-in gain.
    (A) In general. The term "recognized built-in gain" means any gain recognized during the recognition period on the disposition of any asset except to the extent the gain corporation (or, in any case described in subsection (a)(1)(B), the acquiring corporation) establishes that
      (i) such asset was not held by the gain corporation on the acquisition date, or
      (ii) such gain exceeds the excess (if any) of
        (I) the fair market value of such asset on the acquisition date, over
        (II) the adjusted basis of such asset on such date.
    (B) Treatment of certain income items. Any item of income which is properly taken into account for any recognition period taxable year but which is attributable to periods before the acquisition date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account and shall be taken into account in determining the amount of the net unrealized built-in gain.
    (C) Limitation. The amount of the recognized built-in gains for any recognition period taxable year shall not exceed
      (i) the net unrealized built-in gain, reduced by
      (ii) the recognized built-in gains for prior years ending in the recognition period which (but for this section) would have been offset by preacquisition losses.
  (2) Acquisition date. The term "acquisition date" means
    (A) in any case described in subsection (a)(1)(A), the date on which the acquisition of control occurs, or

(B) in any case described in subsection (a)(1)(B), the date of the transfer in the reorganization.

(3) Preacquisition loss.

(A) In general.The term "preacquisition loss" means

(i) any net operating loss carryforward to the taxable year in which the acquisition date occurs, and

(ii) any net operating loss for the taxable year in which the acquisition date occurs to the extent such loss is allocable to the period in such year on or before the acquisition date.

Except as provided in regulations, the net operating loss shall, for purposes of clause (ii), be allocated ratably to each day in the year.

(B) Treatment of recognized built-in loss. In the case of a corporation with a net unrealized built-in loss, the term "preacquisition loss" includes any recognized built-in loss.

(4) Gain corporation. The term "gain corporation" means any corporation with a net unrealized built-in gain.

(5) Control. The term "control" means ownership of stock in a corporation, which meets the requirements of section 1504(a)(2).

(6) Treatment of members of same group. Except as provided in regulations and except for purposes of subsection (b), all corporations which are members of the same affiliated group immediately before the acquisition date shall be treated as 1 corporation. To the extent provided in regulations, section 1504 shall be applied without regard to subsection (b) thereof for purposes of the preceding sentence.

(7) Treatment of predecessors and successors. Any reference in this section to a corporation shall include a reference to any predecessor or successor thereof.

(8) Other definitions. Except as provided in regulations, the terms "net unrealized built-in gain," "net unrealized built-in loss," "recognized built-in loss," "recognition period," and "recognition period taxable year" have the same respective meanings as when used in section 382(h), except that the acquisition date shall be taken into account in lieu of the change date.

(d) *Limitation Also to Apply to Excess Credits or Net Capital Losses.* Rules similar to the rules of subsection (a) shall also apply in the case of any excess credit (as defined in section 383(a)(2)) or net capital loss.

(e) *Ordering Rules for Net Operating Losses, Etc.*

(1) Carryover rules. If any preacquisition loss may not offset a recognized built-in gain by reason of this section, such gain shall not be taken into account in determining under section 172(b)(2) the amount of such loss which may be carried to other taxable years. A similar rule shall apply in the case of any excess credit or net capital loss limited by reason of subsection (d).

(2) Ordering rule for losses carried from same taxable year. In any case in which—

(A) a preacquisition loss for any taxable year is subject to limitation under subsection (a), and

(B) a net operating loss from such taxable year is not subject to such limitation, taxable income shall be treated as having been offset 1st by the loss subject to such limitation.

(f) *Regulations.* The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to ensure that the purposes of this section may not be circumvented through

(1) the use of any provision of law or regulations (including subchapter K of this chapter), or

(2) contributions of property to a corporation.

APPENDIX B

Senate Report No. 96-1035 on H.R. 5043—Bankruptcy Tax Act of 1980

REPORT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE ON H.R. 5043

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Appendix B

BANKRUPTCY TAX ACT OF 1980

November 25 (legislative day, November 20), 1980.—Ordered to be printed

MR. LONG, FROM THE COMMITTEE ON FINANCE, SUBMITTED THE FOLLOWING

REPORT
[To accompany H.R. 5043]

The Committee on Finance, to which was referred the act (H.R. 5043) to amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the act as amended do pass.

I. SUMMARY

A. Tax Treatment of Discharge of Indebtedness

In Public Law 95-598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of a discharge of indebtedness in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill provides tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and makes related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

Bankruptcy or Insolvency

Under the bill, no amount is to be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case, or outside bankruptcy if the debtor is insolvent. Instead, the amount of discharged debt which is excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") is applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets (or in real property held primarily for sale to customers in the ordinary course of a trade or business), the debt discharge amount is applied to reduce the taxpayer's net operating losses and then certain tax credits and capital loss carryovers. Any excess of the debt discharge amount over the amount of reduction in these attributes is applied to reduce asset basis (but not below the amount of the taxpayer's remaining undischarged liabilities) and then to reduce carryovers of the foreign tax credit. Any further remaining debt discharge amount is disregarded, i.e., does not result in income or have other tax consequences.

The bill provides that the taxpayer can elect to apply the debt discharge amount first to reduce basis in depreciable property (or in realty held as inventory), before applying any remaining amount to reduce net operating losses and then other tax attributes in the order stated in the bill. A debtor making this election can elect to reduce basis in depreciable property (or in realty held as inventory) below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers).

To the extent the debtor makes an election to reduce basis in depreciable assets, or reduces basis in assets after reduction in other tax attributes, it is anticipated that Treasury regulations prescribing the order of basis reduction among assets will generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act. If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations.

To insure that ordinary income treatment eventually will be given to the full amount of basis reduction in depreciable or nondepreciable assets, the bill provides that any gain on a subsequent disposition of reduced-basis assets is subject to "recapture" under sections 1245 or 1250 of the Internal Revenue Code.

Outside bankruptcy—solvent taxpayers

The bill modifies the existing Federal income tax election (Code secs. 108 and 1017) under which a solvent taxpayer outside bankruptcy can elect to reduce basis of assets instead of recognizing current income from debt cancellation. As with the rules of the bill applicable to bankrupt or insolvent debtors, the bill provides that the election to reduce basis allowed to solvent debtors outside bankruptcy requires reduction in basis of depreciable assets (or in realty held as inventory).

To the extent that the debtor makes an election to reduce basis, it is anticipated that Treasury regulations prescribing the order of basis reduction among the taxpayer's depreciable assets will generally accord with present Treasury regulations under section 1017 of the Code. If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations. As in the case of bankrupt or insolvent debtors, the bill provides that any gain on a subsequent disposition of reduced-basis assets is subject to "recapture" under Code sections 1245 or 1250.

The bill also provides that in the case of a solvent taxpayer outside bankruptcy, a reduction to the purchaser in the amount of a purchase-money debt, by the seller of the property, is treated for Federal income tax purposes as a purchase price reduction and not as a discharge of indebtedness.

Equity-for-debt rules

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt, except where only a de minimis amount of stock is issued.

By contrast, the bill as passed by the House would have provided that if a corporate debtor issues stock in cancellation of short-term debt or trade credit, the debt discharge rules of the bill would apply to the extent the indebtedness exceeds the value of the stock. It is anticipated that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill will encourage reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

A creditor who receives stock in cancellation of debt can take a bad debt deduction to the same extent as under present law. In order properly to match the character of the gain derived on sale of such stock with its origin, the committee bill provides that any gain on a later sale of the stock by the former creditor will be "recaptured" as ordinary income up to the amount of the creditor's prior deductions against ordinary income.

The bill also provides that the debt discharge rules apply to the extent that the amount of debt transferred by a shareholder to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.

Other rules concerning debt discharge

In addition, other rules in the bill concerning debt discharge relate to debt acquired by a related party, discharge of liabilities payment of which would have given rise to deductions, the tax benefit rule under Code section 111, and discharge of a partnership debt. Also, the bill provides (overturning a contrary position of the Internal Revenue Service) that if the basis of investment credit property is reduced by a debt discharge amount, no investment credit recapture will occur by reason of the reduction.

Effective Date

The provisions of the bill relating to tax treatment of debt discharge apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced after December 31, 1980. In the case of discharge of indebtedness outside bankruptcy cases (or receivership, etc. proceedings), the debt discharge rules of the bill apply to any discharge of indebtedness occurring after December 31, 1980.

The bill also provides an effective date election for debtors in bankruptcy cases commenced on or after October 1, 1979 (but prior to January 1, 1981), and for debtors in receivership, foreclosure, or similar judicial proceedings commenced on or after October 1, 1979 (but prior to January 1, 1981). The debtor in such a case or proceeding can elect to have all the following provisions of the bill apply to all transactions in the case or proceeding: section 2 (tax treatment of discharge of indebtedness); section 4 (corporate reorganization provisions); and sections 5(a), 5(b), 5(c), 5(e), and 5(f) (miscellaneous corporate amendments). If the election is made, all provisions of sections 2 and 4 and all the

above-listed provisions of section 5 of the bill are applicable to all transactions in the case or proceeding and to all parties involved in the case or proceeding.

B. Bankruptcy Estate of an Individual

In general

The bill treats the bankruptcy estate of an individual in a liquidation or reorganization case under the new bankruptcy statute as a separate taxable entity for Federal income tax purposes. Also, the bill provides that no separate taxable entity is created by commencement of a bankruptcy case in which the debtor is an individual in a case under chapter 13 of the new bankruptcy law (adjustment of debts of an individual with regular income), a partnership, or a corporation.

The Federal income tax rules set forth in the bill with respect to a bankruptcy estate of an individual which is treated as a separate taxable entity include rules for allocation of income and deductions between the debtor and the estate, computation of the estate's taxable income, accounting methods and periods of the estate, the treatment of the estate's administrative costs as deductible expenses, carryover of tax attributes between the debtor and the estate, and requirements for filing and disclosure of returns.

Debtor's election to close taxable year

Also, the bill generally gives an individual debtor an election to close his or her taxable year as of the day the bankruptcy case commences. If the election is made, the debtor's Federal income tax liability for the "short" taxable year ending on commencement of the case becomes an allowable claim against the bankruptcy estate. If the election is not made, the commencement of the bankruptcy case does not terminate the taxable year of an individual debtor.

Effective date

These provisions of the bill apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganizations in Bankruptcy

Expansion of reorganization provisions

The bill expands the categories of tax-free corporate reorganizations defined in section 368 of the Code to include a new category of "G" reorganizations. This category includes certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case (or in a receivership, foreclosure, or similar proceeding). Accordingly, the bill terminates the applicability of special rules of current law relating to insolvency reorganizations (Code secs. 371–374).

The bill permits a "G" reorganization to take the form of a triangular reorganization, including a "reverse merger." Also, the bill allows the acquiring corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary. The statutory rule generally governing carryover of tax attributes in corporate reorganizations (Code sec. 381) will apply in the case of a "G" reorganization.

Since "G" reorganizations are subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply generally to corporate reorganizations, a shareholder or security holder who receives securities in a "G" reorganization with a principal amount exceeding the principal amount of securities surrendered is taxed on the excess. Also, money or other "boot" property received in a "G" reorganization is subject to the dividend-equivalence tests which apply to reorganizations generally.

Property attributable to accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) will be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or other property attributable to accrued but unpaid interest on the securities surrendered.

Effective date

These provisions apply to bankruptcy cases commencing after December 31, 1980, and to receivership, foreclosure, or similar judicial proceedings commencing after that date. Also, these provisions will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (described above) is made.

In the case of transactions outside bankruptcy cases and receivership, etc. proceedings, the amendments relating to exchanges of property for accrued interest apply to transactions occurring after December 31, 1980.

D. Miscellaneous Corporate Amendments

The bill makes a number of miscellaneous amendments to the Internal Revenue Code relating to corporate tax issues, including the following.

1. Personal holding company status. Under the bill, a corporate debtor generally is not to be considered a personal holding company, subject to additional taxes on certain passive income, while in a bankruptcy case (or receivership, foreclosure, or similar proceeding). This provision applies to bankruptcy cases commencing after December 31, 1980, and to receivership, etc. proceedings commencing after that date. Also, this provision will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (as described above) is made.

2. Liquidation rule. The corporate nonrecognition tax rules applicable to 12-month liquidations are extended by the bill to cover sales by a corporation in a bankruptcy case (or a receivership, etc. proceeding) of assets, other than assets acquired after commencement of the bankruptcy case, during the entire period from adoption (after commencement of the case) of the plan of liquidation through conclusion of the case. This provision applies to bankruptcy cases (or receivership, etc. proceedings) commencing after December 31, 1980. Also, this provision will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (described above) is made.

3. Subchapter S shareholder. The bill provides that for bankruptcy cases commencing on or after October 1, 1979, the bankruptcy estate of an individual debtor can be an eligible shareholder in a subchapter S corporation.

4. Section 351 applicability. Under the bill, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, are not covered by the nonrecognition rule of section 351 of the Code. Also, the nonrecognition rule does not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case to the extent the stock or securities received in exchange for the assets are used to satisfy the indebtedness of the debtor. The effective date for these provisions is the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

5. Earnings and profits. The bill provides that to the extent the amount of discharged indebtedness is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits. Also, the bill provides that any deficit in earnings and profits is reduced by the paid-in capital of any shareholder whose interest is eliminated in a bankruptcy case. The effective date for this provision is the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

E. Changes in Tax Procedures

The bill coordinates certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in Public Law 95-598.[1]

These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

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[1] In 1978, the Congress enacted legislation (Public Law 95-598) which significantly revised and modernized the substantive law of bankruptcy as well as bankruptcy court procedures. Public Law 95-598 repealed the Bankruptcy Act and substituted a new title 11 in the U.S. Code, completely replacing the former provisions. The new law generally was effective for bankruptcy cases commencing on or after October 1, 1979.

The 1978 statute did not include a "short title" (although it has been designated by some commentators as the "Bankruptcy Reform Act of 1978"). This report refers to the 1978 bankruptcy statute as "P.L. 95-598." The substantive bankruptcy law which was superseded by P.L. 95-598 is referred to as the "Bankruptcy Act."

In this report, the provisions of title 11 of the U.S. Code which were enacted by P.L. 95-598 are cited as "new 11 U.S. Code sec.—." References to the "Code" are to the Internal Revenue Code of 1954, as amended.

In the bill (H.R. 5043), bankruptcy cases to which the substantive provisions of P.L. 95-598 apply—generally, cases commenced on or after October 1, 1979—are referred to as "title 11 cases."

II. EXPLANATION OF THE BILL

A. Tax Treatment of Discharge of Indebtedness (sec. 2 of the bill and secs. 108, 111, 382(b) and 1017 of the Code)

Present Law

In general

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12) of the Internal Revenue Code). For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900, thereby increasing its net worth by $100, the corporation realizes $100 of income in the year of repurchase (United States v. Kirby Lumber Co., 284 U.S. 1 (1931)).

There are several exceptions to the general rule of income realization. Under a judicially developed "insolvency exception," no income arises from discharge of indebtedness if the debtor is insolvent both before and after the transaction;[2] and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess.[3] Treasury regulations provide that the gratuitous cancellation of a corporation's indebtedness by a shareholder-creditor does not give rise to debt discharge income to the extent of the principal of the debt, since the cancellation amounts to a contribution to capital of the corporation.[4] Some courts have applied this exception even if the corporation had previously deducted the amount owed to the shareholder-creditor.[5] Under a related exception, cases have held that no income arises from discharge of indebtedness if stock is issued to a creditor in satisfaction of the debt, even if the creditor was previously a shareholder, and even if the stock is worth less than the face amount of the obligation satisfied.[6] Further, cancellation of a previously accrued and deducted expense does not give rise to income if the deduction did not result in a reduction of tax (Code sec. 111). A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (Code sec. 102).[7]

A debtor which otherwise would be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its assets in accordance with Treasury regulations (Code secs. 108 and 1017). This income exclusion is available if the discharged indebtedness was incurred by a corporation or by an individual in connection with property used in his trade or business. These provisions were intended to allow the tax on the debt discharge income to be deferred and collected through lower depreciation deductions for the reduced-basis assets, or greater taxable gains on sale of the assets.

The Internal Revenue Service takes the position that a reduction in the basis of qualified investment credit property resulting from an income-exclusion election under sections 108 and 1017 of the Code is pro tanto a disposition of the property the basis of which was reduced, resulting in partial recapture of the investment credit allowed upon its purchase (Rev. Rul. 74-184, 1974-1 C.B.8).

Bankruptcy proceedings

The Bankruptcy Act contains certain rules relating to the Federal income tax treatment of discharge of indebtedness in bankruptcy proceedings. However, these rules have been repealed by P.L. 95-598 effective for bankruptcy cases instituted on or after October 1, 1979.

Under the Bankruptcy Act provisions, no income is recognized on cancellation of indebtedness in an insolvency reorganization (under Chapter X). The Act requires the debtor corporation to reduce the basis of its assets by the amount of indebtedness discharged, but not below the fair market value of such assets as of the date the bankruptcy court confirms the reorganization plan.[8] However, under section 372 of the Internal Revenue Code, no basis reduction is required if the cor-

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[2] Treas. Regs. § 161-12(b)(1); *Dallas Transfer & Terminal Warehouse Co. v. Comm'r*, 70 F.2d 95 (5th Cir. 1934).

[3] *Lakeland Grocery* Co., 36 B.T.A. 289 (1937).

[4] Treas. Regs. § 1.61-12(a).

[5] *Putoma Corp. v. Comm'r*, 66 T.C. 652 (1978), *aff'd*, 604 F.2d 734 (5th Cir. 1979).

[6] *Comm'r v. Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946).

[7] Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules. Treas. Regs. § 1.61-12(a).

[8] Secs. 268 and 270 of the Bankruptcy Act.

poration's property is transferred to a successor corporation as part of the bankruptcy reorganization.[9]

Similar rules apply in the case of an "arrangement" (under Chapter XI), a "real property arrangement" (under Chapter XII), and a wage earner's plan (under Chapter XIII), except that no basis reduction is required under a wage earner's plan.[10] In addition, in the case of a Bankruptcy Act discharge other than under an insolvency reorganization or an arrangement described above, income is not realized to the extent the general "insolvency exception" applies.[11]

Reasons for Change

Overview

In P.L. 95-598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of debt discharge in bankruptcy, effective for cases instituted on or after October 1, 1979. The committee's bill provides tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and makes related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy and tax policy. To preserve the debtor's "fresh start" after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability. The bill provides that the debt discharge amount thus excluded from income is applied to reduce the taxpayer's net operating losses and certain other tax attributes, unless the taxpayer elects to apply the debt discharge amount first to reduce basis in depreciable assets (or in realty held as inventory).

In the case of solvent debtors outside bankruptcy, the bill modifies the election (under Code secs. 108 and 1017) permitting such debtors to reduce asset basis in lieu of reporting ordinary income from debt cancellation, as on repurchase of bonds at a discount. Under the bill, a solvent taxpayer can elect to reduce basis only in depreciable assets (or in realty held as inventory).

Debtors given flexibility

The committee believes that these attribute-reduction provisions of the bill give flexibility to the debtor to account for a debt discharge amount in a manner most favorable to the debtor's tax situation. For example, a bankrupt or insolvent debtor which wishes to retain net operating losses and other carryovers will be able to elect to reduce asset basis in depreciable property (or in realty held as inventory). On the other hand, a debtor having an expiring net operating loss which otherwise would be "wasted" will be able (by not making the election) to apply the debt discharge amount first against the net operating loss. Similarly, a solvent debtor can continue to defer recognition of income by electing to reduce basis of depreciable assets (or in realty held as inventory), or (by not electing) can include all or part of the debt discharge amount in income (for example, in order to offset an expiring net operating loss).

At the same time, in developing the rules of the bill, the committee recognized that the basis-reduction mechanism of present law fails to effectuate the Congressional intent of deferring, but eventually collecting tax on, ordinary income realized for debt discharge.

Thus present law permits both solvent and insolvent taxpayers to apply the amount of their discharged debts to reduce the basis of nondepreciable assets which may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, rather than deferring, the tax consequences of debt discharge. Also under present law, a related party (such as the parent corporation of a debtor) can acquire the taxpayer's debt at a discount and effectively eliminate it as a real liability to outside interests, but the debtor thereby avoids the tax treatment which would apply if the debtor had directly retired the debt by repurchasing it.

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[9] While under present law no basis reduction is required if a successor corporation is used in the insolvency reorganization, the Code under present law does not permit the carryover of tax attributes, such as net operating losses, from the debtor to the successor corporation (except possibly in certain situations where the reorganization meets the requirements of secs. 368 and 381 of the Code, in which case net operating losses may be limited by section 382 of the Code, in which case net operating losses may be limited by section 382 of the Code).

[10] Secs. 395, 396, 520, 522, and 679 of the Bankruptcy Act.

[11] Treas. Regs. § 1.61-12(b). *See* text accompanying notes 2 and 3.

In other cases, the debtor may be able to convert ordinary income from discharge of indebtedness into capital gain, as where the debtor reduces basis in a nondepreciable capital asset.

Deferral of ordinary income on debt discharge

Accordingly, the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge. Thus in the case of a bankrupt or insolvent debtor, the debt discharge amount is applied to reduce the taxpayer's net operating losses and certain other tax attributes, unless the taxpayer elects to apply the amount first to reduce basis in depreciable assets. In the case of a solvent debtor outside bankruptcy, the debtor can defer recognition of income, but only by reducing basis in depreciable assets. Similarly, the debtor can defer immediate tax consequences of debt discharge by reducing basis in real property held as inventory. A subsequent disposition of such reduced-basis realty will result in recognition of a larger amount of ordinary income, just as reduction in basis of depreciable assets results in lower depreciation deductions to offset ordinary income.

To insure that the debt discharge amount eventually will result in ordinary income (and cannot be converted to capital gain), the bill provides that any gain on a subsequent disposition of the reduced-basis property will be subject to a "recapture" under rules similar to those now applicable with respect to depreciation recapture. Also, the bill contains rules relating to discharge of indebtedness as a capital contribution, acquisition of debt by a related party, discharge of partnership debt, and other income tax aspects of discharge of indebtedness.

Stock-for-debt rules to encourage reorganizations

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt. The bill as passed by the House would have provided that if a corporate debtor issues stock in cancellation of short-term debt or trade credit, the debt discharge rules of the bill would have applied to the extent the indebtedness exceeded the value of the stock.

The committee believes that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill encourages reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns. However, the committee does not believe that these rules should apply if only a *de minimis* amount of stock is issued for the outstanding debt, so that the general rules on debt forgiveness cannot thereby be circumvented.

The deduction available under present law for certain creditors receiving stock in cancellation of a debt remains unchanged. However, the committee bill provides that any gain on a later sale of the stock by the former creditor will be "recaptured" as ordinary income up to the amount of the creditor's prior deductions against ordinary income.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

Postponement of effective dates for bankruptcy cases

Under the bill as introduced and passed by the House, the provisions relating to tax treatment of debt discharge (section 2), corporate reorganizations in bankruptcy (section 4), and certain miscellaneous corporate amendments (section 5) would have applied for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979. In light of the time that has elapsed since introduction of the bill, the committee believes that the provisions of sections 2, 4, and 5 of the bill should apply to bankruptcy cases (or receivership, etc. proceedings) commenced after December 31, 1980.

However, some taxpayers may have entered into bankruptcy reorganizations with the expectation that the bill would be enacted with the original retroactive effective dates. Accordingly, the committee bill allows a bankrupt or insolvent debtor, in the case of proceedings commenced on or after October 1, 1979, to elect to have all the debt discharge and related provisions of the bill (sections 2, 4, and 5), apply retroactively as under the original effective date. No change would be made in the effective date for rules applicable to debt discharge, etc. outside bankruptcy (i.e., transactions occurring after December 31, 1980).

Explanation of Provisions

Debt discharge in bankruptcy

In general

Under the bill, no amount is to be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case.[12] Instead, the amount of discharged debt which is excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") is to be applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets (or in real property held primarily for sale to customers in the ordinary course of a trade or business), the debt discharge amount is applied to reduce the taxpayer's tax attributes in the following order:

(1) net operating losses and carryovers;

(2) carryovers of the investment tax credit (other than the ESOP credit), the WIN credit, the new jobs credit, and the credit for alcohol used as a fuel;

(3) capital losses and carryovers;

(4) the basis of the taxpayer's assets (both depreciable and nondepreciable); and

(5) carryovers of the foreign tax credit.[13]

The reduction in each category of carryovers is made in the order of taxable years in which the items would be used, with the order determined as if the debt discharge amount were not excluded from income.[14] For this purpose, any limitations on the use of credits that are based on the income of the taxpayer are disregarded.

After reduction of the attributes specified in categories (1), (2), and (3) above, any remaining debt discharge amount is applied to reduce asset basis, but not below the amount of the taxpayer's remaining undischarged liabilities. (Thus, a sale of all the taxpayer's assets immediately after the discharge generally will not result in income tax liability unless the sale proceeds and cash on hand exceed the amount needed to pay off the remaining liabilities.) Any amount of debt discharge which remains after such reduction in asset basis, including any debt discharge amount which remains unapplied solely by virtue of the limitation just described with respect to undischarged liabilities, is applied to reduce carryovers of the foreign tax credit.

Any amount of debt discharge which is left after attribute reduction under these rules is disregarded, i.e., does not result in income or have other tax consequences.

Election to reduce basis in certain property

The bill provides that the taxpayer can elect, in accordance with Treasury regulations, to apply all or a portion of the debt discharge amount first to reduce basis (but not below zero) in depreciable property[15] or in real property held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of Code sec. 1221(1)). Any remaining amount is then applied to reduce

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[12] For purposes of these rules, the term "bankruptcy case" (referred to in the bill as a "title 11 case") means a case under new title 11 of the U.S. Code, but only if the taxpayer is under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

[13] For purposes of the attribute reduction rules, credits are reduced at the rate of 50 cents for each dollar of debt discharge amount. This flat-rate reduction avoids the complexity of determining a tax on the debt discharge amount of determining how much of the amount would be used up by the credits for purposes of determining other reductions. Except for reductions in credit carryovers, the specified tax attributes are reduced one dollar for each dollar of debt discharge amount.

[14] Thus in the case of net operating losses or capital losses, the debt discharge amount first reduces the current year's loss and then reduces the loss carryovers in the order in which they arose. The investment credit carryovers are reduced on a FIFO basis, and the other credit carryovers also are reduced in the order they would be used against taxable income. These reductions are made after the computation of the current year's tax.

[15] For this purpose, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor could not reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of that property. *See Harry H. Kem*, Jr., 51 T.C. 455 (1968), *aff'd*, 432 F.2d 961 (9th Cir. 1970).

net operating losses and other tax attributes in the order described above. A debtor making this election can elect to reduce basis (but not below zero) in depreciable property or in realty held as inventory below the amount of remaining liabilities (i.e., where the debtor would rather reduce basis in such assets than reduce carryovers).

In addition, the bill provides that, for purposes of this election, stock held by a parent corporation in a subsidiary is treated as depreciable property (or as realty held as inventory) if the parent and subsidiary file a consolidated return for the taxable year in which the discharge occurs, and if the subsidiary agrees to reduce its basis in depreciable property (or in real property held as inventory) which the subsidiary holds.[16] Thus, if the debtor is a parent corporation which files a consolidated return with a subsidiary, the debtor can elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of stock it holds in the subsidiary to the extent the subsidiary consents to reduce the basis of depreciable property which it holds (or realty which it holds as inventory).

An election first to reduce basis in depreciable property in realty held as inventory must be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once made, the election can be revoked by the taxpayer only with the consent of the Internal Revenue Service.

Recapture rule

If the basis of property is reduced pursuant to the attribute reduction rules in the bill, any gain on a subsequent disposition of the property is subject to "recapture" under section 1245 of the Code or, in the case of depreciable realty, under section 1250. (This recapture rule applies to any reduced-basis asset, whether depreciable or nondepreciable, and whether or not a disposition of such asset otherwise would be subject to recapture under Code sections 1245 or 1250.) The computation of the amount of straight-line depreciation (under sec. 1250(b)) is determined as if there had been no reduction of basis under section 1017.

Basis reduction—general rule

To the extent a debtor makes an election to reduce basis in depreciable property, or reduces basis in assets after reduction of other attributes, the particular properties the bases of which are to be reduced will be determined pursuant to Treasury regulations. It is anticipated that the order of reduction prescribed in such regulations will generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act (Treas. Regs. §§ 1.1016-7 and 1.1016-8). If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations.

In order to avoid interaction between basis reduction and reduction of other attributes, the bill provides that the basis reduction takes effect on the first day of the taxable year following the year in which the discharge took place. If basis reduction is required in respect of a discharge of indebtedness in the final year of a bankruptcy estate, the reduction is to be made in the basis of assets acquired by the debtor from the estate at the time so acquired.

In a bankruptcy case involving an individual debtor to which new section 1398 of the Code (as added by the bill) applies, any attribute reduction required under the bill applies to the attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arise after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522.

Debt discharge outside bankruptcy—insolvent debtors

The bill provides that if a discharge of indebtedness occurs when the taxpayer is insolvent (but is not in a bankruptcy case), the amount of debt discharge is excluded from gross income up to the amount by which the taxpayer is insolvent.[17] The excluded amount is applied to reduce tax attributes in the

[16] This rule can be applied successively through a chain of corporations so long as the lowest tier subsidiary reduces its basis in actual depreciable property (or realty which it holds as inventory).

[17] The bill defines "insolvent" as the excess of liabilities over the fair market value of assets, determined with respect to the taxpayer's assets and liabilities immediately before the debt discharge. The bill provides that except pursuant to section 108(a)(1)(B) of the Code (as added by the bill), there is to be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness.

same manner as if the discharge had occurred in a bankruptcy case. Any balance of the debt discharged which is not excluded from gross income (because it exceeds the insolvency amount) is treated in the same manner as debt cancellation in the case of a wholly solvent taxpayer.

Debt discharge outside bankruptcy—solvent debtors

In the case of a solvent taxpayer outside bankruptcy, the bill modifies the present rule (secs. 108 and 1017 of the Code) permitting an election to reduce the basis of assets in lieu of reporting income from discharge of indebtedness. Under the election as modified, income from debt discharge will not currently be recognized by a solvent debtor outside bankruptcy to the extent the debtor elects to reduce basis in depreciable property or in real property held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of Code sec. 12211(1)).[18]

If the debtor elects to reduce basis in depreciable property, the particular depreciable assets the bases of which are to be reduced (but not below zero) will be determined pursuant to Treasury regulations. It is anticipated that the order of reduction among depreciable assets of the taxpayer will generally accord with present Treasury regulations (Treas. Regs. §§ 1.1017-1 and 1.1017-2). If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced (but not below zero) will be determined pursuant to Treasury regulations. The bill provides that the basis reduction takes effect on the first day of the taxable year following the year in which the discharge takes place.

In addition, the bill provides that, for purposes of this election, stock held by a parent corporation in a subsidiary is treated as depreciable property (or as realty held as inventory) if the parent and subsidiary file a consolidated return for the taxable year in which the discharge occurs, and if the subsidiary agrees to reduce its basis in depreciable property (or in real property held as inventory) which the subsidiary holds.[19] Thus, if the debtor is a parent corporation which files a consolidated return with a subsidiary, the debtor can elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of stock it holds in the subsidiary to the extent the subsidiary consents to reduce the basis of depreciable property which it holds (or realty which it holds as inventory).

An election first to reduce basis in depreciable property or in realty held as inventory must be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once made, the election can be revoked by the taxpayer only with the consent of the Internal Revenue Service.

To the extent a solvent taxpayer outside the bankruptcy does not make an election to reduce basis in depreciable property (or in realty held as inventory) in lieu of reporting income from debt discharge, or to the extent the debt discharge amount exceeds the maximum reduction which can be made through an election, the excess constitutes income from discharge of indebtedness which constitutes gross income for Federal income tax purposes (sec. 61(a)(12) of the Code).

Recapture rule

To ensure that ordinary income treatment eventually will be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis property is subject to "recapture" under section 1245 of the Code or, in the case of depreciable realty, under section 1250. (This recapture rule applies to any reduced-basis property, whether or not a disposition of such property otherwise would be subject to recapture under Code sections 1245 or 1250.) The computation of the amount of straight-line depreciation (under sec. 1250(b)) is determined as if there had been no reduction for basis under section 1017.

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[18] The exclusion from gross income under section 108(a) of the Code (as amended by the bill) applies, in the case of a discharge which does not occur in a title 11 case and which does not occur when the taxpayer is insolvent, where the indebtedness discharged is "qualified business indebtedness." The latter term means indebtedness of the taxpayer if both (1) the indebtedness was incurred or assumed by a corporation, or by an individual in connection with property used in his trade or business, and also (2) the taxpayer makes an election to reduce the basis of depreciable assets or realty held as inventory).

For this purpose, the term "depreciable property" is defined the same way as in the case of the election by a bankrupt or insolvent taxpayer to reduce the basis of depreciable property (*see* note 14 *supra*).

[19] This rule can be applied successively through a chain of corporations so long as the lowest tier subsidiary reduces its basis in actual depreciable property (or realty which it holds as inventory).

Certain reductions as purchase price adjustments

The bill provides that if the seller of specific property reduces the debt of the purchaser which arose out of the purchase, and the reduction to the purchaser does not occur in a bankruptcy case or when the purchaser is insolvent, then the reduction to the purchaser of the purchase-money is to be treated (for both the seller and the buyer) as a purchase price adjustment on that property. This rule applies only if but for this provision the amount of the reduction would be treated as income from discharge of indebtedness.

This provision is intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether, in a particular case to which the provision applies, the debt reduction should be treated as discharge income or a true price adjustment. If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision does not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment. Also, this provision does not apply where the debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.

Equity-for-debt rules

Issuance of stock

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt.

However, the general "stock-for-debt exception" will not apply if only a nominal or token amount of stock is issued for the debt, to be determined according to all the facts and circumstances, so that the forgiveness rules may not be circumvented by the issuance of nominal or token shares to a creditor who had no real equity interest in the corporation.

Also, the general "stock-for-debt exception" will not apply to the debt of an unsecured creditor[20] in a workout[21] if that creditor receives an amount of stock (by value) which is less than one-half the amount of stock that such creditor would receive if all the corporation's unsecured creditors, to the extent their debts are either cancelled or satisfied with the debtor's stock in the workout, received a pro-rata amount of the stock issued.

Thus, for example, if creditor A held $1,000 of unsecured debt against a debtor corporation and if, in a workout, the debtor corporation fully satisfied $10,000 of its unsecured debt (including the debt to A) by the transfer of $6,000 of its stock, A must receive at least $300 of stock in satisfaction of its claim (assuming no other property is transferred) in order for the debtor to rely, with respect to the stock issued to A, on the general rule of present law that no debt discharge income is recognized and no attribute reduction is required when a corporation's debt is satisfied by the issuance of its own stock. If creditor A receives only $100 of stock for his $1,000 debt under these facts, then the debtor corporation will have a debt discharge amount of $900 with respect to issuance of stock to creditor A. If creditor A receives $300 or more of stock for his $1,000 debt under these facts, then the debtor corporation will not have any debt discharge amount with respect to issuance of stock to creditor A.

If a corporate debtor issues a package of stock and other property in cancellation of debt, the cash and other property are to be treated as satisfying an amount of debt equal to the amount of cash and the value of other property, and the stock is to be treated as satisfying the remainder of the debt. Consequently, there will be no debt discharge amount recognized by the debtor (unless the de minimis exception applies) on issuance of stock and other property for debt.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee

[20] For this purpose, a claim is considered as secured by a lien on property only to the extent of the fair market value of the creditor's interest in such property. Any claim in excess of such value is treated as a separate claim of an unsecured creditor. This is consistent with the approach taken in new 11 U.S. Code sec. 506.

[21] A "workout" includes a title 11 case (within the meaning of Code sec. 368(a)(3)(A)) or other transaction or series of transactions involving a significant restructuring of the debt of a corporation in financial difficulty.

bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

Recapture on disposition of stock

The committee bill provides that if a creditor acquires stock of the debtor corporation in exchange for the corporation's indebtedness, then upon subsequent disposition of the stock, any deduction taken with respect to the debt either as a bad debt deduction (under Code secs. 166(a) or (c)), reduced by any gain on the exchange, or as an ordinary loss on the exchange shall be subject to "recapture" under the rules of Code section 1245.[22]

Thus, for example, assume that corporation A made a $1,000 short-term loan to corporation B on July 1, 1980, and that corporation A, for its taxable year 1982, takes an $800 deduction for partially worthless bad debt under Code section 166(a). Assume further that on March 1, 1983, B satisfies the principal of the debt with B stock worth $500, resulting in a gain to A of $300. If A later disposes of the B stock for $1,500, $500 of A's gain will be treated as ordinary income ($800 bad debt deduction less $300 gain on receipt of the stock). In addition, if the stock is disposed of in a tax-free transaction (for example, by reason of secs. 354 or 1306), the potential recapture will carry over to the stock received.

In the case of a cash-basis creditor, any amount not taken into account by reason of his method of accounting shall be treated the same as a deduction allowed with respect to the debt. A special rule is provided in the bill for taxpayers on the reserve method for bad debts under Code section 166(c).

Capital contributions

The bill provides that the discharge of indebtedness rules apply to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.[23] Thus, the discharge of indebtedness rules apply when a cash-basis taxpayer contributes to the capital of an accrual-basis corporation a debt representing an accrued expense previously deducted by the corporation.[24]

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[22] For purposes of these recapture rules, the bill provides that the term "debtor corporation" includes a successor corporation, and that stock of a corporation in control of the debtor corporation is treated as stock of the debtor. Also, the bill provides that similar recapture rules apply in the case of discharge of partnership indebtedness.

[23] For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as salary, and the cash-basis employee does not include the $1,000 in income. In a later year, the shareholder-employee forgives the debt.

Under the bill, the corporation must account for a debt discharge amount of $1,000. If the corporation is insolvent or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it can elect to reduce basis of depreciable assets (or of realty held as inventory) by $1,000 in lieu of recognizing $1,000 of income in the year of discharge.

On the other hand, if the shareholder-employee were on the accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required.

[24] 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 (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 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.

Debt acquired by related party
The bill provides that, for purposes of determining income of the debtor from discharge of indebtedness, an outstanding debt acquired from an unrelated party by a party related to the debtor is treated as having been acquired by the debtor to the extent provided in regulations issued by the Treasury Department.

For purposes of this rule, a person is treated as related to the debtor if the person is (1) a member of a controlled group of corporations (as defined for purposes of Code sec. 414(b)) of which group the debtor is a member; (2) a trade or business treated as under common control with respect to the debtor (within the meaning of Code secs. 414(b) or 414(c)); (3) either a partner in a partnership treated as controlled by the debtor or a controlled partnership with respect to the debtor (within the meaning of Code sec. 707(b)(1)); or (4) a member of the debtor's family or other person bearing a relationship to the debtor specified in Code section 267(b). The definition of "family" for this purpose also includes a spouse of the debtor's child or grandchild.

This rule is intended to treat a debtor as having its debt discharged if a party related to the debtor purchases the debt at a discount (for example, where a parent corporation purchases at a discount debt issued by its subsidiary).[25]

Other rules concerning debt discharge
No disposition on basis reduction. If the basis of qualified investment credit property is reduced by a debt discharge amount under the rules of the bill, no investment credit recapture tax is incurred, because the reduction would not be considered a disposition. This rule overturns the position taken by the Internal Revenue Service in Rev. Rul. 74-184, supra, in the case of a solvent debtor making an election under sections 108 and 1017 of the Code (as amended by the bill), and precludes extension of that position to bankrupt or insolvent debtors.[26]

Indebtedness of taxpayer. The debt discharge rules of the bill apply with respect to discharge of any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property.

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[25] It is intended that the Treasury Department has authority to and will issue regulations 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.

[26] No inference is intended, by virtue of adoption of the no-disposition rule of the bill as described in the text above, as to whether the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra*, represents a correct interpretation of Federal income tax law prior to the effective date of the bill's no-disposition rule.

A purchase price adjustment (whether or not described in new sec. 108(e)(5) of the Code, as added by this bill) continues to constitute an adjustment for purposes of the investment credit rules of the Code.

Unamortized premium and discount. The bill provides that the amount taken into account with respect to any discharge of indebtedness is to be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.[27]

"Lost" deductions. The bill provides that if the payment of a liability would have given rise to a deduction, the discharge of that liability does not give rise to income or require reduction of tax attributes. For example, assume a cash-basis taxpayer owes $1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt (whether or not as a contribution to capital), then the discharge does not give rise to income or require any reduction of tax attributes.

Tax benefit rule. The bill clarifies present law by providing that in applying the tax benefit rule of Code section 111 in order to determine if the recovery of an item is taxable, a deduction is treated as having produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurs. Thus, if an accrual-basis taxpayer incurs a deductible obligation to pay rent in 1980, and that obligation is forgiven in 1981, the rent deduction is treated as having produced a reduction in tax even if it had entered into the calculation of a net operating loss that had not expired at the end of 1981 but had not been used as of that time.

Real estate investment trusts. To qualify as a real estate investment trust (REIT), an organization must satisfy, among other requirements, source-of-income tests establishing that it has primarily passive income from real estate investments (Code sec. 856). The bill provides that income from cancellation of indebtedness is not to be taken into account for these source-of-income tests. For example, if a solvent REIT investing primarily in mortgages has debt cancellation on redemption of bonds, and such amount would be includible in gross income under the rules of the bill (absent an election to apply such amount to reduce the basis of depreciable assets or realty held as inventory), the amount of such income is not to be taken into account for purposes of Code section 856.

Amendment to Code section 382(b). The committee bill provides that creditors of a debtor corporation are to be treated as shareholders in applying the continuity rules of Code section 382(b) in a title 11 or similar case (within the meaning of Code sec. 368(a)(3)(A), as added by the bill). The House bill would have limited this rule to reorganizations under Code section 368(a)(1)(G), as added by the bill.

Partnerships

The bill provides that the rules of exclusion from gross income and reduction of tax attributes in section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at the partnership level.[28] Accordingly, income from discharge of a partnership debt is not excludable at the partnership level under amended section 108. Instead, such income is treated as an item of income which is allocated separately to each partner pursuant to section 702(a) of the Code.

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a deemed distribution (under sec. 752), in turn resulting in a reduction (under sec. 733) of the partner's basis in the partnership. The section 733 basis reduction, which offsets the section 705 basis increase, is separate from any basis reduction pursuant to the attribute-reduction rules of the bill.

The tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner depends on whether that partner is in a bankruptcy case, is insolvent (but not in bankruptcy case), or is solvent (and not in a bankruptcy case). For example, if the particular partner is bankrupt, the debt discharge amount is excluded from gross income pursuant to amended section 108 and is applied to reduce the partner's net operating losses and other tax attributes, unless the partner elects to apply the amount first to reduce basis in depreciable property.[29] If the particular partner is solvent (and not in a bankruptcy case), the amount allocated to that partner is included in that partner's gross income except to the extent the partner elects to reduce basis of depreciable assets.

The bill provides that, in connection with these attribute-reduction rules, a partner's interest in a partnership is to be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership if the partnership agrees to make a corresponding reduction in the basis of the partnership property with respect to such partner (in a

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[27] This provision of the bill is not intended to be a change from the rules of current law as to adjustments for unamortized premium and discount.

[28] The effect of these provisions of the bill is to overturn the decision in *Stackhouse v. U.S.*, 441 F.2d 465 (5th Cir. 1971).

[29] For purposes of this explanation of the partnership rules, the term "depreciable property" also refers to real property held for sale to customers in the ordinary course of business.

manner similar to that which would be required if the partnership had made an election under Code section 754 to adjust basis in the case of a transfer of a partnership interest).[30]

Technical amendments

The bill amends section 703(b) of the Code, relating to elections of a partnership, to provide that any election under sections 108(b)(5) or 108(d)(4) of the Code (as amended by the bill) with respect to income from discharge of indebtedness is to be made by each partner separately and not by the partnership. Section 118(c) of the Code, relating to cross references, is amended to add a reference to the rules of the bill on capital contributions of indebtedness.

Effective Date

General rule

The amendments to the Internal Revenue Code made by section 2 of the bill apply to transactions in a bankruptcy case if the case commences after December 31, 1980; to transactions in a receivership, foreclosure, or similar proceeding if the proceeding commences after December 31, 1980; and to other transactions which occur after December 31, 1980 (except that the provisions of section 2 do not apply to any transaction in a bankruptcy case which began prior to January 1, 1981 or in a receivership, foreclosure, or similar proceeding which proceeding began before January 1, 1981, even if such transaction occurs after December 31, 1980).[31]

Special effective date election

The bill also provides an effective date election for debtors in bankruptcy cases commenced on or after October 1, 1979 (but prior to January 1, 1981), and for debtors in receivership, foreclosure, or similar judicial proceedings commenced on or after October 1, 1979 (but prior to January 1, 1981).

The debtor (or debtors, if there is more than one debtor in the case) in such a case or proceeding can elect, with the approval of the court, to have the following provisions of the bill apply to transactions in the case or proceeding, notwithstanding the general effective date of the bill:

section 2 (tax treatment of discharge of indebtedness);
section 4 (corporate reorganization provisions; and
sections 5(a), 5(b), 5(c), 5(e), and 5(f) (miscellaneous corporate amendments).

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[30] For example, assume that the partnership is the debtor in a bankruptcy case which begins March 1, 1981, and that in the bankruptcy case a partnership liability in the amount of $30,000 is discharged. The partnership has three partners. The three partners have equal distributive shares of partnership income and loss items under section 702(a) of the Code. Partner A is the debtor in a bankruptcy case; partner B is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner C is solvent, and is not a debtor in a bankruptcy case.

Under section 705 of the Code, each partner's basis in the partnership is increased by $10,000, i.e., his distributive share of the income of the partnership. (The $30,000 debt discharge amount constitutes income of the partnership for this purpose, inasmuch as the income exclusion rules of amended sec. 108 do not apply at the partnership level.) However, also by virtue of present law, each partner's basis in the partnership is decreased by the same amount (Code secs. 752 and 733). Thus, there is not net change in each partner's basis in the partnership resulting from discharge of the partnership indebtedness except by operation at the partner level of the rules of sections 108 and 1017 of the Code (as amended by the bill).

In the case of bankrupt partner A, the $10,000 debt discharge amount must be applied to reduce net operating losses and other tax attributes as specified in the bill, unless A elects first to reduce the basis of depreciable assets. The same tax treatment applies in the case of insolvent partner B. In the case of solvent partner C, such partner can elect to reduce basis in depreciable assets in lieu of recognizing $10,000 of income from discharge of indebtedness.

If A, B, or C elects to reduce basis in depreciable assets, such partner may be permitted, under the Treasury regulations, to reduce his basis in his partnership interest (to the extent of his share of partnership depreciable property), because the bill treats that interest as depreciable property. However, a partner may reduce basis in his interest in the partnership only if the partnership makes a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).

[31] Where the new recapture rules for stock apply (generally, to stock acquired after December 31, 1980), those rules apply without regard to when the deductions to be recaptured were allowed.

If the election is made, all provisions of sections 2 and 4 and all the above-listed provisions of section 5 of the bill are applicable to all transactions in the case or proceeding and to all parties involved in the case or proceeding. Thus, the debtor may not elect to have only certain of these provisions apply to transactions in the case or proceeding, and may not elect to have the provisions apply only to certain transactions in the case or proceeding.

An effective date election is to be made at such time and in such manner as prescribed by Treasury regulations, taking into account the need for all parties involved in the case or proceeding to be aware of the election. The election, once made, is irrevocable.

B. Rules Relating to Title 11 Cases for Individuals (sec. 3 of the bill; new secs. 1398 and 1399 and secs. 6012 and 6103 of the Code)

Effect of Bankruptcy Law

Under bankruptcy law, the commencement of a liquidation or reorganization case involving an individual debtor creates an "estate" which consists of property formerly belonging to the debtor. The bankruptcy estate generally is administered by a trustee for the benefit of creditors, and it may derive its own income and incur expenditures. At the same time, the individual is given a "fresh start"—that is, wages earned by the individual after commencement of the case and after-acquired property do not become part of the bankruptcy estate, but belong to the individual, and certain property may be set aside as exempt.

Reasons for Change

At present, there are no rules in the Internal Revenue Code specifying whether the bankruptcy estate constitutes a taxable entity apart from the individual debtor; and, if so, how tax attributes are to be allocated between the estate and the debtor. This has resulted in uncertainty and litigation concerning the Federal income tax liability of the bankruptcy estate and the debtor. The provisions of section 3 of the bill, adding new sections 1398 and 1399 to the Internal Revenue Code, provide the first comprehensive statutory treatment of these issues.

In addition, the committee has concluded that an individual debtor in a bankruptcy case generally should be given an election to close his or her taxable year at the date of bankruptcy. If a debtor makes such an election, the debtor's Federal income tax liability for the "short" taxable year ending with commencement of the bankruptcy case becomes collectible out of the bankruptcy estate as a liability incurred before bankruptcy, to the extent the estate has assets with which to pay debts of that priority. Since income items (or benefits of prebankruptcy transactions that gave rise to tax liability) may have passed to the bankruptcy trustee, it is appropriate that the tax liability be collectible out of estate assets as a prebankruptcy liability. To the extent that assets of the bankruptcy estate are not sufficient to pay any tax due for that year, the bankruptcy statute provides that the remaining liability is not dischargeable in the bankruptcy case and hence can be collected from the individual debtor after the case.

Explanation of Provisions

1. Debtor and bankruptcy estate as separate entities

Present law

For Federal income tax purposes, the estate created on commencement of a bankruptcy proceeding with respect to an individual debtor is treated as a new taxable entity, separate from the individual (Rev. Rul. 72-387, 1972-2 C.B. 632). Accordingly, the trustee must file a tax return (Form 1041) for the bankruptcy estate if the gross income of the estate, for the period beginning with filing of the petition or for any subsequent taxable year, is $600 or more.

The taxable year of the individual debtor is not terminated on commencement of the bankruptcy proceeding. On the individual's return (Form 1040 or 1040A) for the year in which the bankruptcy proceeding commenced, the individual reports all income earned by him or her during the entire year (including income earned by the individual before commencement of the proceeding, even though any assets derived from such income pass to the bankruptcy estate), but does not report any income earned by the bankruptcy estate.

General provisions of bill

The bill, like present law, treats the bankruptcy estate of an individual as a separate taxable entity for Federal income tax purposes. The separate entity rules under the bill (new Code sec. 1398)[32] apply if a bankruptcy case involving an individual debtor is brought under chapter 7

[32] In this report, provisions of the Internal Revenue Code which are added by section 3 of the bill are cited as "new Code sec.—".

(liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95-598. No separate taxable entity is created on commencement of a case under chapter 13 of new 11 U.S. Code (adjustment of debts of an individual with regular income).[33]

Exception

If a bankruptcy case involving an individual is commenced but subsequently dismissed by the bankruptcy court, the estate is not treated as a separate entity (new Code sec. 1398(b)(1)). In this situation, where the bankruptcy case does not run to completion, it is appropriate to treat the debtor's tax status as if no proceeding had been brought.[34]

Partnerships, corporations

The bill provides that no taxable entity results from commencement of a bankruptcy case involving a partnership or corporation. This rule (new Code sec. 1399) reverses current Internal Revenue Service practice as to partnerships, under which the estate of a partnership in bankruptcy is treated as a taxable entity (Rev. Rul. 68-48. 1968-1 C.B. 301), but is the same as present law with respect to commencement of a bankruptcy case involving a corporation (Treas. Reg. § 1.641(b)-2(b)).

Accordingly, the bankruptcy trustee of a partnership in a bankruptcy case is required to file annual information returns (under section 6031 of the Code) for the partnership. Also, the bankruptcy trustee of a corporation in a bankruptcy case, as under present law, is required to file annual income tax returns and pay corporate income tax for the corporation (sec. 6012(b)(3) of the Code: Rev. Rul. 79-120, 1979-1 C.B. 382).

2. Debtor's election to close taxable year

In general

The bill gives an individual debtor an election to close his or her taxable year as of the day before the date on which the bankruptcy case commences (the "commencement date"). If the election were made, the debtor's taxable year which otherwise would include the commencement date is divided into two "short" taxable years of less than 12 months. The first such year ends on the day before the commencement date; the second such year begins on the commencement date (new Code sec. 1398(d)(3)(A)). If the election were not made, the commencement of the bankruptcy case does not affect the taxable year of an individual debtor (new Code sec. 1398(d)(2)).

As a result of the debtor's making the election, his or her Federal income tax liability for the first short taxable year becomes (under bankruptcy law) an allowable claim against the bankruptcy estate as a claim arising before bankruptcy. Accordingly, any tax liability for that year is collectible from the estate, depending on the availability of estate assets to pay debts of that priority. Inasmuch as any such tax liability for an electing debtor's first short taxable year is not dischargeable, the individual debtor remains liable for any amount not collected out of the bankruptcy estate (new 11 U.S. Code sec. 523(a)(1)). If the debtor does not make the election, no part of the debtor's tax liability from the year in which the bankruptcy case commences is collectible from the estate, but is collectible directly from the individual debtor.

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[33] The rationale for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 or chapter 11 cases.

For purposes of the separate entity rules under new Code section 1398, a partnership is not treated as an individual. The interest in a partnership of a debtor who is an individual is taken into account under new Code section 1398 in the same manner as any other interest of the debtor (new Code sec. 1398(b)(2)).

[34] If the estate is not treated as a separate entity because the bankruptcy case was dismissed, the debtor includes on his or her return(s), for the year(s) the estate was in existence, any gross income, deductions, or credits which otherwise would be tax items of the estate. The estate, although temporarily in existence under bankruptcy law prior to dismissal of the case, does not constitute a taxable entity for Federal income tax purposes.

If the election is made, the debtor is required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period had been made (new Code sec. 1398(d)(3)(F)).

Availability of election

The election provided under the bill is available in cases to which new section 1398 of the Code applies. Accordingly, the election is available to an individual debtor in a bankruptcy case under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95-598, except where such case is commenced but subsequently dismissed by the bankruptcy court. Also, the bill provides that the election is not available to a debtor who has no assets other than property which he or she may treat as exempt property under new 11 U.S. Code section 522 (new Code sec. 1398(d)(3)(C)). In the latter instance, since there would be no assets in the bankruptcy estate out of which the debtor's tax liability for the period prior to the commencement date could be collected, there is no reason to authorize termination of the taxable year.

Due date, manner of election

The election must be made on or before the 15th day of the fourth month following the commencement date—i.e., by the date on which a return would be due for the first short taxable year if the election were made, determined without regard to any extension for filing such return. For example, if the bankruptcy case commences on March 10, the election must be made by July 15 of that year. The election is to be made in such manner as prescribed by Treasury regulations, but an election is not conditioned on approval of the Internal Revenue Service, as under section 442 of the Code. The election, once made, is irrevocable (new Code sec. 1398(d)(3)(D)).

Spousal election

If the debtor making the election was married on the date the bankruptcy case involving him or her commenced, the debtor's spouse can join in the election to close the taxable year, but only if the debtor and the spouse file a joint return for the first short taxable year (new Code sec. 1398(d)(3)(B)). The filing of a joint return for the first short taxable year does not require the debtor and the spouse to file a joint return for the second short taxable year.

If during the same year a bankruptcy case involving the debtor's spouse were commenced, the spouse can elect to terminate his or her then taxable year as of the day before the commencement date, whether or not the spouse previously had joined in the debtor's election. If the spouse previously had joined in the debtor's election, or if the debtor had not made an election, the debtor can join in the spouse's election. But if the debtor had made an election and the spouse had not joined in the debtor's election, the debtor cannot join in the spouse's election, inasmuch as the debtor and the spouse, having different taxable years, could not file a joint return for a year ending with the spouse's commencement date (sec. 6013 of the Code).

Illustrative example

The rules relating to spousal elections under the bill are illustrated by the following example.

Assume that husband and wife are calendar-year taxpayers, that a bankruptcy case involving only the husband commences on March 1, 1982, and that a bankruptcy case involving only the wife commences on October 1, 1982.

If the husband does not make an election, his taxable year would not be affected; i.e., it does not terminate on February 28. If the husband does make an election, his first short taxable year would be January 1 through February 28; his second short taxable year would begin March 1. The wife could join in the husband's election, but only if they file a joint return for the taxable year January 1 through February 28.

The wife could elect to terminate her then taxable year on September 30. If the husband had not made an election, or if the wife had not joined in the husband's election, she would have (if she made the election) two taxable years in 1982—the first from January 1 through September 30, and the second from October 1 through December 31. If the husband had not made an election to terminate his taxable year on February 28, the husband could join in an election by his wife, but only if they file a joint return for the taxable year January 1 through September 30. If the husband had made an election but the wife had not joined in the husband's election, the husband could not join in an election by the wife to terminate her taxable year on September 30, since they could not file a joint return for such year.

If the husband had made the election and the wife had joined in it, she would have two additional taxable years with respect to her 1982 income and deductions (if she makes the election relating to her own bankruptcy case)—the second short taxable year would be March 1 through

September 30, and the third short taxable year would be October 1 through December 31. The husband could join in the wife's election if they file a joint return for the second short taxable year. If the husband does so join in the wife's election, they could file joint returns for the short taxable year ending December 31, but would not be required to do so.

3. Computation of bankruptcy estate's tax liability

Gross income

Under the bill, the gross income of the bankruptcy estate of an individual consists of (1) any gross income of the individual debtor, other than any amount received or accrued as income by the debtor before the commencement of the case, which under bankruptcy law (new 11 U.S. Code) constitutes property of the bankruptcy estate, and (2) the gross income of the estate beginning on and after the date the case commenced (new Code sec. 1398(e)(1)).

Attribute carryover

The estate succeeds to the following income tax attributes of the debtor (determined as of the first day of the debtor's taxable year in which the case commences):

(a) net operating loss carryovers;

(b) capital loss carryovers;

(c) credit carryovers;

(d) charitable contribution carryovers;

(e) recovery exclusions (under sec. 111 of the Code);

(f) the debtor's basis in and holding period for, and the character in the debtor's hands of, any asset acquired (other than by sale or exchange) from the debtor;

(g) the debtor's method of accounting; and

(h) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(g)).

For example, the regulations could allow the estate the benefit of section 1341 of the Code if the estate repays income which the debtor received under claim of right.

Character of expenditures

Under present law, it is not clear whether certain expenses or debts paid by the trustee are deductible if the trustee does not actually operate the debtor's trade or business (and if such expenses are not incurred in a new trade or business of the estate). To alleviate this problem, the bill provides that an amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would be deductible or creditable by the debtor had the debtor remained in the same trades, businesses, or activities after the case commenced as before and had the debtor paid or incurred such amount. The same test is applied to determine whether amounts paid by the estate constitute wages for purposes of Federal employment taxes (new Code sec. 1398(e)(4)).

Administrative expenses

Under present law, it is unclear in certain circumstances whether administrative and related expenses of the bankruptcy estate are deductible by the estate (see Rev. Rul. 68-48, 1968-1 C.B. 301). The bill provides (new Code sec. 1398(h)(1)) that the estate can deduct (a) any administrative expense allowed under new 11 U.S. Code sec. 503 and (b) any fee or charge assessed against the estate under 28 U.S. Code, ch. 123 (court fees and costs). Such deductions are available whether or not considered trade or business expenses or investment expenses, but are subject to disallowance under other provisions of the Internal Revenue Code, such as section 263 (capital expenditures), 265 (expenses relating to tax-exempt interest), or 275 (certain taxes).

Under present law, any deduction otherwise available for administrative or related expenses may be lost, since no carryover deduction is permitted for expenses not incurred in a trade or business. The trustee often cannot pay administrative expenses until the end of the bankruptcy proceeding; unless considered trade or business expenses, the unused amount cannot be carried back and deducted against income of the bankruptcy estate received in earlier years.

To alleviate this problem, the bill provides that any amount of the new deduction for administrative, etc. expenses not used in the current year can be carried back by the estate three years (but only to a taxable year of the estate) and forward seven years (new Code sec. 1398(h)(2)). These carryovers are "stacked" after the net operating loss deductions (allowed by sec. 172 of the Code) for the particular year. An administrative, etc. expenses which is deductible solely under new Code sec. 1398(h)(1), or a carryover deduction for such expense, is allowable only to the estate (new Code sec. 1398(h)(2)(D)).

Carryback of estate's net operating losses

If the bankruptcy estate itself incurs a net operating loss (apart from losses passing to the estate from the individual debtor), the bill provides that the bankruptcy estate can carry back its net operating losses not only to previous taxable years of the estate, but also to taxable years of the individual prior to the year in which the case commenced (new Code sec. 1398(j)(2)). Similarly, the bill allows the bankruptcy estate to carry back excess credits, such as the investment tax credit, to prebankruptcy taxable years of the individual debtor.

Tax rate schedule, etc.

Except as otherwise provided in new Code section 1398, the taxable income of the bankruptcy estate is computed in the same manner as in the case of an individual. The estate is allowed a deduction of $1,000 under section 151 of the Code as its personal exemption. Under the bill, the zero bracket amount for the estate and the tax rate schedule applicable to the estate are the same as for married individuals filing separate returns (new Code sec. 1398(c)). The estate is not eligible for income averaging.

Returns of estate

Under the bill, the trustee is required to file a Federal income tax return on behalf of the bankruptcy estate for any year in which the estate's gross income of $2,700 or more (sec. 3(b) of the bill and new sec. 6012(a)(9) of the Code), and to pay the estate's tax liability due for that year (new Code sec. 1398(c)(1)). No return need be filed and no income tax would be due if gross income for the year is less than $2,700.

Change of accounting period

The estate is permitted to change its annual accounting period (taxable year) one time without obtaining approval of the Internal Revenue Service as otherwise required under section 442 of the Code (new Code sec. 1398(j)(1)). This rule permits the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate, and then to submit a return for such "short year" for an expedited determination of tax liability pursuant to new 11 U.S. Code sec. 505.

Disclosure of returns

The bill provides that the estate's Federal income tax return is open (upon written request) to inspection by or disclosure to the individual debtor (sec. 3(c) of the bill and amended sec. 6103(e) of the Code). Such disclosure is necessary so that the debtor can properly determine any amount of tax attributes to which the debtor would succeed on termination of the bankruptcy estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset from the bankruptcy estate to the individual debtor on termination of the estate would not be treated as a disposition giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(2)).

4. Computation of individual's tax liability

Gross income, deductions, credits

If any item of gross income of the debtor realized after commencement of the bankruptcy case is treated under new Code section 1398(e)(1) as gross income of the bankruptcy estate (because under bankruptcy law such income constitutes property of the estate), that item is not included by the debtor as gross income on his or her return or a joint return with the debtor's spouse (new Code sec. 1398(e)(2)).

This provision of the bill, treating such income items as gross income of the estate rather than of the individual, is intended to override otherwise applicable "assignment of income" principles of tax law. For example, if the estate were entitled under bankruptcy law to a salary payment earned by the debtor before the case commences but paid after that date, the amount of the payment is included in the estate's gross income and is not to be included in the debtor's gross income.

If any item of deduction or credit of the debtor is treated under new Code section 1398(e)(3) as a deduction or credit of the bankruptcy estate, that item is not allowable to the debtor as a deduction or credit on his or her return or a joint return with the debtor's spouse (new Code section 1398(e)(3)). The rule is intended to insure that no particular item or deduction or credit can be allowable to both the debtor and the estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset from the individual debtor to the bankruptcy estate is not treated as a disposition giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(1)). For example, such a transfer of an installment obligation is not treated as a disposition giving rise to acceleration of gain under section 453(d) of the Code.

Carryback of net operating loss

The bill provides that an individual debtor cannot carry back, to a year that preceded the year in which the case was commenced, any net operating loss or credit carryback from a taxable year ending after commencement of the bankruptcy case (new Code sec. 1398(j)(2)(B)). As noted above, the bill would permit the bankruptcy estate to carry back its net operating loss deduction to offset the prebankruptcy income of the individual debtor.

Attribute carryover

On termination of the bankruptcy estate, the debtor would succeed to the following tax attributes of the estate (including such attributes which first arose during administration of the estate):

(a) net operating loss carryovers;

(b) capital loss carryovers;

(c) credit carryovers;

(d) charitable contribution carryovers;

(e) recovery exclusions (under sec. 111 of the Code);

(f) the estate's basis in and holding period for, and the character in the estate's hands of, any asset acquired (other than by sale or exchange) from the estate;[35] and

(g) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(i)).

Disclosure of returns

In a bankruptcy case to which new Code section 1398 applies (determined without regard to whether the case is dismissed), the Federal income tax returns of the debtor for the taxable year in which the bankruptcy case commenced and preceding years are open (upon written request) to inspection by or disclosure to the trustee of the bankruptcy estate. (This disclosure is necessary so that the trustee properly may determine attribute carryovers to the estate and may carry back deductions to preceding years of the debtor.) In an involuntary case, however, no such disclosure of the trustee could be made prior to the time the bankruptcy court has entered an order for relief unless that court finds that such disclosure is appropriate for purposes of determining whether an order for relief should be entered (sec. 3(c) of the bill and amended sec. 6103(e) of the Code).

Also under the bill, prior year returns of the debtor in a bankruptcy case, or of a person whose property is in the hands of a receiver, are open (upon written request) to inspection by or disclosure to the trustee or receiver, but only if the Internal Revenue Service finds that such trustee or receiver, in his fiduciary capacity, has a material interest which would be affected by information contained in the return.

5. Technical amendment

Section 443(c) of the Code, relating to cross references, is amended by adding a cross reference to new Code section 1398(d)(3)(E), with respect to returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year.

6. Effective date

The amendments made by section 3 of the bill apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

[35] In a bankruptcy case to which new Code sec. 1398 applies, any attribute reduction under section 2 of the bill applies to tax attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522. The tax attributes to the estate, as so reduced, carry over (to the extent unused on termination of the estate) to the individual debtor pursuant to new Code sec. 1398(i).

C. Corporate Reorganization Provisions (sec. 4 of the bill and secs. 354, 355, 357, 368, and 381 of the Code)

Present Law

Definition of reorganization

A transfer of all or part of a corporation's assets, pursuant to a court order in a proceeding under chapter X of the Bankruptcy Act (or in a receivership, foreclosure, or similar proceeding), to another corporation organized or utilized to effectuate a court-approved plan may qualify for tax-free reorganization treatment under special rules relating to "insolvency reorganizations" (secs. 371–374 of the Internal Revenue Code).

These special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in section 368 of the Code. Also, the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.[36] While some reorganizations under chapter X of the Bankruptcy Act may be able to qualify for nonrecognition treatment under Code section 368, other chapter X reorganizations may be able to qualify only under the special rules of sections 371–374 and not under the general reorganization rules of section 368.

Triangular reorganizations

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371–374, the stock or securities used to acquire the assets of the corporation in bankruptcy must be the acquiring corporation's own stock or securities. This limitation generally precludes corporations in bankruptcy from engaging in so-called triangular reorganizations, where the acquired corporation is acquired for stock of the parent of the acquiring corporation. By contrast, tax-free triangular reorganizations generally are permitted under the general rules of Code section 368.

Transfer to controlled subsidiary

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371–374, it is not clear under present law whether and to what extent the acquiring corporation may transfer assets received into a controlled subsidiary. In the case of other corporate reorganizations, the statute expressly defines the situations where transfers to subsidiaries are permitted (Code sec. 368(a)(2)(C)).

Carryover of tax attributes

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371-374, court cases have held that attributes (such as net operating losses) of the corporation in bankruptcy do not carry over to the new corporation. In the case of other corporate reorganizations, however, specific statutory rules permit carryover of tax attributes to the surviving corporation (Code sec. 381).

"Principal amount" rule; "boot" test

In a corporate reorganization, generally the exchange of stock or securities of one corporation for those of another corporation is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered, or to the extent of the principal amount of the securities received if no securities are surrendered (Code secs. 354(a)(2)(B) and 356(d)(2)). Also, "boot" (money or property other than stock and securities permitted to be received without recognition of gain) received in a corporate reorganization is subject to the dividend-equivalence test of Code section 356. These rules do not apply under present law to insolvency reorganizations qualifying only under Code sections 371-374.

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[36] Under present law, it is not clear to what extent creditors of an insolvent corporation who receive stock in exchange for their claims may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule, under which the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation. Generally, the courts have found the "continuity of interest" test satisfied if the creditors' interests were transformed into proprietary interests prior to the reorganization (e.g., *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Treas. Reg. § 1.371-1(a)(4)). It is unclear whether affirmative steps by the creditors are required or whether mere receipt of stock is sufficient.

Treatment of accrued interest
Under present law, a claim for unpaid interest is treated as an integral part of the security to which it relates, so that the surrender of the security together with the claim for unpaid interest is treated only as the surrender of a security. Thus, the nonrecognition provisions apply to an exchange of a security with accrued but unpaid interest although the unpaid interest would have been taxable as ordinary income if paid separately.[37]

Reasons for Change
The committee believes that the provisions of existing Federal income tax law which are generally applicable to tax-free corporate reorganizations should also apply to reorganizations of corporations in bankruptcy or similar proceedings, in order to facilitate the rehabilitation of financially troubled businesses.

Also, the committee believes that a creditor who exchanges securities in a corporate reorganization (including an insolvency reorganization) should be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or any other property for accrued but unpaid interest on the securities surrendered.

Explanation of Provisions
Section 4 of the bill generally conforms the tax rules governing insolvency reorganizations with the existing rules applicable to other corporate reorganizations. These provisions are the same as section 4 of the House bill.

Definition of reorganization

In general
The bill adds a new category—"G" reorganizations—to the general Code definition of tax-free reorganizations (sec. 368(a)(1). The new category includes certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case under new title 11 of the U.S. Code, or in a receivership, foreclosure, or similar proceeding[38] in a Federal or State court.[39]

The special tax rules (Code secs. 371-374) now applicable to insolvency reorganizations continue to apply only to bankruptcy proceedings commenced prior to October 1, 1979, except that the bill does not terminate the applicability of the rules in sections 374(c) and 374(e) of the Code governing tax-free exchanges under the final system plan for ConRail.

In order to facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law. To achieve this purpose, the new "G" reorganization provision does not require compliance with State merger laws (as in category "A" reorganizations), does not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category "C"), and does not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category "D").

The "G" reorganization provision added by the bill requires the transfer of assets by a corporation in a bankruptcy or similar case, and the distribution (in pursuance of the court-approved reorganization plan) of stock or securities of the acquiring corporation in a transaction which qualifies under sections 354, 355, or 356 of the Code. This distribution requirement is designed to assure that either substantially all of the assets of the financially troubled corporation, or assets which consist of an active business under the tests of section 355, are transferred to the acquiring corporation.

"Substantially all" test
The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it is intended that

[37] *Carman v. Comm'r*, 189 F.2d 363 (2nd Cir. 1951); Rev. Rul. 59-98, 1959-1 C.B. 76.

[38] For this purpose, the definition of a receivership, foreclosure, or similar proceeding is the same as under present section 371 of the Code.

[39] Under the bill, asset transfers in a receivership, foreclosure, or similar proceeding involving a financial institution (to which section 585 or 593 of the Code applies) before a Federal or State agency are treated in the same manner as transfers in such a proceeding before a court. Thus, for example, asset transfers in a proceeding under 12 U.S.C. sec. 1729 involving a savings and loan association can qualify as a "G" reorganization.

facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction is not precluded from satisfying the "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.[40]

Relation to other provisions

A transaction which qualifies as a "G" reorganization is not to be treated as also qualifying as a liquidation under section 332, an incorporation under section 351, or a reorganization under another category of section 368(a)(1) of the Code.[41]

A transaction in a bankruptcy or similar case which does not satisfy the requirements of new category "G" is not thereby precluded from qualifying as a tax-free reorganization under one of the other categories of section 368(a)(1). For example, an acquisition of the stock of a company in bankruptcy, or a recapitalization of such a company, which transactions are not covered by the new "G" category, can qualify for nonrecognition treatment under sections 368(a)(1)(B) or (E), respectively.

Continuity of interest rules

The "continuity of interest" requirement which the courts and the Treasury have long imposed as a prerequisite for nonrecognition treatment for a corporate reorganization must be met in order to satisfy the requirements of new category "G". Only reorganizations—as distinguished from liquidations in bankruptcy and sales of property to either new or old interests supplying new capital and discharging the obligations of the debtor corporation—can qualify for tax-free treatment.

It is expected that the courts and the Treasury will apply to "G" reorganizations continuity-of-interest rules which take into account the modification by P.L. 95-598 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes.

Triangular reorganizations

The bill permits a corporation to acquire a debtor corporation in a "G" reorganization in exchange for stock of the parent of the acquiring corporation rather than for its own stock.

In addition, the bill permits an acquisition in the form of a "reverse merger" of an insolvent corporation (i.e., where no former shareholder of the surviving corporation receives any consideration for his stock) in a bankruptcy or similar case if the former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation which has a value equal to at least 80 percent of the value of the debt of the surviving corporation.[42]

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[40] Because the stated intent for adding the new "G" category is not relevant to interpreting the "substantially all" test in the case of other reorganization categories, the comments in the text as to the appropriate interpretation of the "substantially all" test in the context of a "G" reorganization are not intended to apply to, or in any way to affect interpretations under present law of, the "substantially all" test for other reorganization categories.

[41] However, if a transfer qualifying as a "G" reorganization also meets the requirements of section 351 or qualifies as a reorganization under section 368(a)(1)(D) of the Code, the "excess liability" rule of section 357(c) applies if any former shareholder of the transferor corporation receives consideration for his stock, but does not apply if no former shareholder of the transferor corporation receives any consideration for his stock (i.e., if the corporation is insolvent). This rule parallels present law, under which insolvency reorganizations under sections 371 or 374 are excluded from the application of section 357(c).

[42] Priority claims described in new 11 U.S. Code section 1129(a)(9) which are paid in cash may be excluded from this determination.

Transfer to controlled subsidiary
The bill permits a corporation which acquires substantially all the assets of a debtor corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary without endangering the tax-free status of the reorganization. This provision places "G" reorganizations on a similar footing with other categories of reorganizations.

Carryover of tax attributes
Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (Code sec. 381) also applies in the case of a "G" reorganization. This eliminates the so-called "clean slate" doctrine.[43]

"Principal amount" rule; "boot" test
Under the bill, "G" reorganizations are subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations.

Accordingly, an exchanging shareholder or security holder of the debtor company who receives securities with a principal amount exceeding the principal amount of securities surrendered is taxable on the excess, and an exchanging shareholder or security holder who surrenders no securities is taxed on the principal amount of any securities received. Also, any "boot" received is subject to the general dividend-equivalence test of Code section 356.

Treatment of accrued interest
Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) is treated as receiving interest income on the exchange to the extent the security holder receives new securities, stock, or any other property attributable to accrued but unpaid interest (including accrued original issue discount) on the securities surrendered. This provision, which reverses the so-called *Carman* rule,[44] applies whether or not the exchanging security holder realizes gain on the exchange overall. Under this provision, a security holder which had previously accrued the interest (including original issue discount) as income recognizes a loss to the extent the interest is not paid in the exchange.

Example
The reorganization provisions of the bill are illustrated in part by the following example.

Assume that Corporation A is in a bankruptcy case commenced after December 31, 1980. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100,000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction qualifies as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A recognizes no gain or loss on the transfer of its assets to B (Code sec. 361). B's basis in the assets is $75,000 (sec. 362), and B succeeds to A's net operating loss carryover (sec. 381).

Under the bill, the pro-rata distribution of B stock to A's creditors does not result in income from discharge of indebtedness or require attribute reduction.

Assume the same facts as above except that B also transfers $10,000 in cash, which is distributed by A to its creditors. Although A would otherwise recognize gain on the receipt of boot in an exchange involving appreciated property, the distribution by A of the $10,000 cash to those creditors having a proprietary interest in the corporation's assets for continuity of interest purposes prevents A from recognizing any gain (Code sec. 361(b)(1)(A)).[45]

Technical and conforming amendments
Section 4(h) of the bill makes technical and conforming amendments of the Internal Revenue Code.

1. Amendment of section 354(b). Paragraphs (1) and (2) of Code section 354(b), relating to exception to general rule on exchanges of stock and securities in certain reorganizations, are amended by adding references to new subparagraph "G" of section 368(a)(1).

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[43] The bill also provides that creditors of a debtor corporation in a title 11 or similar case are to be treated as shareholders in applying the continuity rules of Code sec. 382(b).

[44] *See* note 2 *supra*.

[45] *See* Code sec. 371(a)(2)(A) and Treas. Reg. § 1.371-1(b) for a similar rule relating to distribution of boot to creditors in an insolvency reorganization under present law.

2. Amendment of section 357(c)(2). Code section 357(c)(2), providing exceptions to the general rule with respect to liabilities in excess of basis on transfers to controlled corporations, is amended to add an exception for any exchange pursuant to a plan of reorganization under new category "G" of section 368(a)(1) if no former shareholder of the transferor corporation receives any consideration for his stock.[46]

3. Amendment of section 368(a)(1). A conforming amendment is made to Code section 368(a)(1) to take into account the addition of new category "G" reorganizations.

4. Amendment of section 368(b). Code section 368(b), defining "party to a reorganization," is amended to include references to new category "G" reorganizations.

5. Technical change. A change is made in the table of sections for part IV of subchapter C of chapter 1 of the Code.

Effective Date

The amendments made by section 4 of the bill apply to bankruptcy cases commencing after December 31, 1980 and to receivership, foreclosure, or similar judicial proceedings commencing after that date. Also, these amendments will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of the report).

In the case of transactions outside bankruptcy cases and receivership, etc. proceedings, the amendments made by section 4(e) of the bill, relating to exchanges of property for accrued interest, apply to transactions occurring after December 31, 1980.

D. Miscellaneous Corporate Amendments (Sec. 5 of the Bill)

1. Exception from personal holding company status (sec. 5(a) of the bill and sec. 542 of the Code)

Present Law

Under present law, a corporation in a bankruptcy or insolvency proceeding may become subject to the personal holding company tax on certain passive income (sec. 541 of the Internal Revenue Code) if its assets are converted to investments which produce passive income before the corporation is liquidated.

Reasons for Change

The committee believes that the personal holding company tax generally should not apply to corporations in bankruptcy or insolvency proceedings, since financially troubled corporations under court supervision generally are not used to avoid income tax on their shareholders.

Explanation of Provision

Under this provision, a corporation subject to court jurisdiction in a bankruptcy or similar case[47] is not to be considered a personal holding company. This exception is not available, however, if a major purpose in commencing or continuing the case is avoidance of the personal holding company tax. This provision is the same as section 5(a) of the House bill.

Effective Date

The amendment made by this provision applies to bankruptcy cases commencing after December 31, 1980 and to similar cases commenced after that date. Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of this report).

2. Repeal of special treatment for certain railroad stock redemptions (sec. 5(b) of the bill and sec. 302 of the Code)

Present Law

Present law provides that any distribution in redemption of stock issued by a railroad corporation pursuant to a reorganization plan under section 77 of the Bankruptcy Act gives rise to capital gain, even if under the general redemption distribution tests the stockholder would realize ordinary income (sec. 302(b)(4) of the Code).

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[46] *See* note 6 *supra*.

[47] The terms "bankruptcy case" and "similar case" refer, respectively, to (1) cases under new 11 U.S. Code and (2) receivership, foreclosure, or similar proceedings in a Federal or State court (or, in the case of a financial institution, a Federal or State agency).

Reasons for Change
The committee believes that the Federal income tax treatment of redemption of certain railroad corporation stock should be the same as applies in the case of redemption of all other stock.

Explanation of Provision
This provision repeals the special rule giving automatic capital gain treatment in the case of redemptions of certain stock issued by railroad corporations in bankruptcy. This provision is the same as section 5(b) of the House bill.

Effective Date
The amendment made by this provision applies to a redemption of stock issued after December 31, 1980 (other than stock issued pursuant to a plan of reorganization approved on or before that date). Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of this report).

3. Application of section 337 liquidation rule to corporations in bankruptcy (sec. 5(c) of the bill and sec. 337 of the Code)

Present Law
Under present law, a corporation which adopts a plan of liquidation and within 12 months thereafter liquidates in a distribution to shareholders generally does not recognize gain or loss on sales within that period (sec. 337 of the Code). The Internal Revenue Service has ruled that this provision does not apply if, as in the case of an insolvency proceeding, the assets are transferred on liquidation to creditors rather than to shareholders (Rev. Rul. 56-387, 1956-2 C.B. 189).

Reasons for Change
The committee believes that nonrecognition treatment should be extended to sales of certain assets by liquidating corporations in bankruptcy or similar cases. In addition, inasmuch as insolvency proceedings may last longer than 12 months, the committee believes that the nonrecognition period should likewise be extended to the termination of the case. Because the nonrecognition period thus would extend to termination of the case, the committee believes that, in order to preclude tax-free "churning" of assets, nonrecognition treatment should not be available on sales of property (other than bulk sales of inventory) acquired after adoption of the liquidation plan.

Explanation of Provision
This provision allows a corporation in a bankruptcy or similar case[48] to sell certain of its assets tax-free where the corporation, after the case commences, adopts a plan of complete liquidation and completes the liquidation before the termination of the case.

The period of nonrecognition begins on the date of adoption (after commencement of the case) of a plan of liquidation and ends on the date the case terminates. It is intended that under the provision, the liquidating corporation could retain sufficient assets to pay administrative claims following the close of the case. This provision does not apply to assets acquired on or after the date of adopting the liquidation plan, other than to inventory sold in bulk.[49]

Effective Date
The amendment made by this provision applies to bankruptcy cases commencing after December 31, 1980 and to similar cases commencing after that date. Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of this report).

4. Estate of individual in bankruptcy as subchapter S shareholder (sec. 5(d) of the bill and sec. 1371 of the Code)

Present Law
Under present law, only individuals, estates, and certain trusts are permitted to be shareholders of subchapter S corporations (sec. 1371 of the Code). Failure to satisfy this rule disqualifies the election of the corporation under subchapter S.

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[48] *See* note 1 *supra*.
[49] Only one bulk sale in any case can qualify for this treatment.

The Internal Revenue Service has ruled that an "estate" for subchapter S purposes includes only the estate of a decedent and not the estate of an individual in bankruptcy (Rev. Rul. 66-266, 1966-2 C.B. 356). Accordingly, the Revenue Service also has ruled that the filing of a voluntary petition in bankruptcy by a shareholder terminates the subchapter S election as of the beginning of the taxable year in which the petition is filed (Rev. Rul. 74-9, 1974-1 C.B. 241). However, the U.S. Tax Court has held that the filing of a petition seeking financial rehabilitation of a debtor under the debt arrangement provisions of the Bankruptcy Act does not create a new entity apart from the debtor and does not cause the termination of a subchapter S election.[50]

Reasons for Change

The committee is concerned that if bankruptcy of an individual shareholder causes termination of a subchapter S election, other shareholders may be adversely affected by an event over which they had no control. The committee believes that the estate of an individual in a bankruptcy case should be permitted to be an eligible shareholder for purposes of the provisions of subchapter S.

Explanation of Provision

Under the bill, the bankruptcy estate of an individual is permitted to be an eligible shareholder in a subchapter S corporation. Thus, a corporation's subchapter S election is not terminated because of commencement of a bankruptcy case involving an individual who is a shareholder in the corporation. In addition, the bankruptcy estate of an individual which owns stock in a corporation can consent to an election under subchapter S made by the corporation after commencement of the bankruptcy case. This provision is the same as section 5(d) in the House bill.

Effective Date

The amendment made by this provision applies to bankruptcy cases commenced on or after October 1, 1979.

5. Certain transfers to controlled corporations (sec. 5(e) of the bill and sec. 351 of the Code)

Present Law

Under present law, if property is transferred to a corporation controlled by the transferor, no gain or loss is recognized on the transfer (sec. 351 of the Code). For this purpose, property includes (1) indebtedness of the transferee corporation not evidenced by a security[51] and (2) a claim for accrued interest on indebtedness of the transferee corporation.[52]

Reason for Change

The committee believes that creditors holding debt not evidenced by a security who exchange their claims against a debtor corporation for stock of the corporation should recognize gain or loss on the exchange. This treatment will accord with the treatment of these creditors on an exchange under a plan of reorganization.

In addition, the committee believes that a transfer of assets to a corporation by a debtor in a bankruptcy or insolvency proceeding where the stock received is transferred to creditors should be treated in the same manner as if the property had been transferred to the creditors, who then transferred the property to a controlled corporation. This rule is designed to prevent the incorporation by a debtor of high-basis, low-value assets where a transfer of the assets directly to the creditors followed by a transfer by the creditors to a controlled corporation would result in a fair market value basis to the corporation.

Explanation of Provision

Under the provision, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, are not covered by the nonrecognition rule of section 351 of the Code.

Also, the nonrecognition rule does not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case[53] to the extent the stock or securities received in exchange for the assets are used to satisfy the indebtedness of the debtor. Accordingly, gain or loss is recognized to the debtor upon the debtor's transfer of assets to the controlled corporation if the stock is then transferred to creditors pursuant to a plan approved in a bankruptcy or similar case. (If less than all the stock is transferred to creditors, a proportionate share of gain or loss is recognized.) Since the

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[50] *CHM Company*, 68 T.C. 31 (1977).

[51] *Alexander F. Duncan*, 9 T.C. 468 (1947), acq. 1948-2 C.B. 2; Rev. Rul. 77-81, 1977-1 C.B. 97.

[52] *See Carman v. Comm'r.*, 189 F.2d 363 (2d Cir. 1951).

[53] *See* note 1 *supra*.

basis of the stock received is adjusted for any gain or loss recognized, the amount recognized on the transfer of the stock to the creditors reflects any amount recognized on the incorporation transfer.

Thus, the sum total of income or loss to the debtor in the two transfers is the same as if the assets had been transferred directly to the creditors. However, the basis of the assets in the hands of the corporation also is adjusted by any gain or loss recognized on the transfer to the corporation, thus reducing any "built-in" loss on assets which had depreciated in value.[54]

This provision is the same as section 5(e) of the House bill.

Effective Date

The effective date for this provision is the same as for section 2 of the bill, relating to income from discharge of indebtedness.

6. Effect of discharge of indebtedness on earnings and profits (sec. 5(f) of the bill and sec. 312 of the Code)

Present Law

Under present law, the effect of discharge of indebtedness on the earnings and profits of a corporation in a bankruptcy proceeding is unclear.[55]

Reason for Change

The committee believes that income from discharge of indebtedness should increase earnings and profits whether or not current tax is imposed on that income. The bankruptcy considerations underlying deferral of recognition of such income by a debtor in a bankruptcy case do not justify extending tax forgiveness to shareholders receiving nonliquidating distributions from the corporation. Also, the committee believes that a corporation's deficit in earnings and profits should be reduced by the amount of the paid-in capital of any stockholder whose interest is extinguished in a bankruptcy or similar case, since it represents no part of the stock of the creditors who become the owners of the corporation.

Explanation of Provision

The bill provides that to the extent that income from discharge of indebtedness (including an amount excluded from gross income pursuant to section 108 of the Code, as amended by this bill) is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits (although reduced depreciation deductions or increased gains on sales of reduced-basis assets would affect earnings and profits in the years such deductions are taken or sales made). Otherwise, discharge of indebtedness income, including amounts excluded from gross income (pursuant to section 108 of the Code, as amended by this bill), increases the earnings and profits of the corporation (or reduces a deficit).

In addition, the committee bill provides that any deficit in earnings and profits is reduced (but positive earnings and profits will not be created) by the paid-in capital of any shareholder whose interest is eliminated in a bankruptcy or similar case.

Effective Date

The effective date for this provision is the same as for section 2 of the bill, relating to income from discharge of indebtedness.

E. Changes in Tax Procedures (Sec. 6 of the Bill)

1. Coordination with bankruptcy court procedures (secs. 6(a), (b), (c), (d), and (g) of the bill and secs. 6213, 6503, 6871, and 7464 of the Code)

Procedures Under Bankruptcy Act

Bankruptcy court jurisdiction

In the case of an individual debtor, the commencement of a bankruptcy proceeding creates an estate. This estate, which is under control of the bankruptcy court, consists of all assets of the individual other than exempt property and certain assets acquired after the proceeding begins. The assets of the bankruptcy estate are not subject to levy by the Internal Revenue Service for the debtor's prepetition

[54] This rule does not apply to a transfer under a plan of reorganization, since no gain or loss is recognized by reason of section 361 of the Code.

[55] In the case of *Meyer v. Comm'r*, 383 F.2d 883 (8th Cir. 1967), the Eighth Circuit held that earnings and profits did not arise where indebtedness was discharged under the Bankruptcy Act. The Internal Revenue Service has announced that it will not follow the Meyer decision to the extent that the amount of debt discharged exceeds the reduction in basis of the taxpayer's assets (Rev. Rul. 75-515, 1975-2 C.D. 117).

income tax liabilities, and generally can be reached only through the Service's filing of a proof of claim in the bankruptcy court.

The bankruptcy court has jurisdiction to determine the debtor's liability for any unpaid tax, whether or not assessed, unless the liability was adjudicated prior to bankruptcy by a court of competent jurisdiction (sec. 2a (2A) of the Bankruptcy Act). In proceedings under the Bankruptcy Act,[56] a determination by the bankruptcy court of a prepetition tax liability of an individual debtor is binding on the Internal Revenue Service and on the trustee of the bankruptcy estate. However, the determination might not settle the personal liability of an individual debtor for the amount, if any, of prepetition nondischargeable tax claims which are not satisfied out of the assets of the bankruptcy estate. Accordingly, if the bankruptcy court rules in favor of the Revenue Service with respect to a nondischargeable tax claim, the debtor may be able to force the Service to relitigate the issue if the claim cannot be fully paid out of estate assets.

Effect on Tax Court Jurisdiction

Under present Federal income tax law (sec. 6871 of the Code) as applicable to Bankruptcy Act proceedings, the Internal Revenue Service is authorized, on institution of a bankruptcy proceeding, immediately to assess any income tax liabilities against the debtor. The Service is not required to follow the normal procedure under which a deficiency notice is issued to the taxpayer and the taxpayer may challenge an asserted income tax liability in the U.S. Tax Court without payment of the tax.

Even if a statutory deficiency notice had been issued and the time for filing a Tax Court petition had not expired before commencement of the bankruptcy proceeding, the debtor still is barred from contesting the asserted liability in the Tax Court (i.e., from litigating without first paying the disputed amount) if the Revenue Service exercises its immediate assessment authority. Present income tax law likewise provides that any portion of a claim for nondischargeable taxes allowed in a bankruptcy proceeding but not satisfied out of assets in the estate shall be paid by the taxpayer after termination of the bankruptcy proceeding (sec. 6873 of the Code).

Under the law applicable to Bankruptcy Act proceedings, the U.S. Tax Court thus loses jurisdiction to determine the debtor's personal liability for prepetition taxes unless a Tax Court case had been filed prior to the bankruptcy proceeding. Accordingly, unless the debtor can invoke the jurisdiction of the bankruptcy court and that court makes a determination, the debtor is precluded from prepayment review of an asserted income tax liability. The debtor's only recourse is to pay the tax and then contest the issue through the refund claim procedure of the Internal Revenue Service and subsequent refund litigation in the U.S. District Court or U.S. Court of Claims.

If a notice of deficiency had been issued and a Tax Court case filed prior to institution of the bankruptcy proceeding, but the Tax Court had not reached a decision as to the debtor's income tax liability, both the bankruptcy court and the Tax Court have jurisdiction to determine the tax liability issue. A decision by the Tax Court would not necessarily bind the estate of the bankrupt, unless the trustee had intervened in the Tax Court litigation. A decision by the bankruptcy court might not necessarily bind the individual debtor, unless the debtor individually had invoked the bankruptcy court's jurisdiction.

Thus, under the law applicable to Bankruptcy Act proceedings, in certain circumstances there may be duplicative litigation concerning the debtor's tax liability. In other circumstances, the debtor may be precluded from obtaining prepayment review of prepetition tax liabilities.

New Bankruptcy Statute (P.L. 95-598)

New 11 U.S. Code section 505(a) continues the jurisdiction of the bankruptcy court to determine liability for a tax deficiency, regardless of whether it has been assessed, unless it has been adjudicated by a court of competent jurisdiction prior to filling of the bankruptcy petition.[57] The new law,

[56] The Bankruptcy Act was repealed by P.L. 95-598, effective for bankruptcy cases commencing on or after October 1, 1979, but remains in effect for bankruptcy proceedings commenced prior to that date.

[57] Under the law applicable to Bankruptcy Act proceedings, the trustee of a bankruptcy estate must proceed in courts other than the bankruptcy court to seek a refund of Federal taxes paid by the debtor. While the trustee succeeds to any right to refund for tax overpayments, the bankruptcy court has jurisdiction only to allow claims against the bankruptcy estate, and not to enforce claims against third parties.

New 11 U.S. Code sec. 505(a) expands the jurisdiction of the bankruptcy court to include determination of refund claims. To invoke the bankruptcy court's jurisdiction, the trustee must file an administrative claim for refund with the Internal Revenue Service (if the debtor had not done so prior to commencement of the bankruptcy case). If a claim filed by the trustee is denied or if 120 days elapse without action by the Internal Revenue Service, the court has jurisdiction to determine the refund issue.

effective for bankruptcy cases commenced on or after October 1, 1979, also seeks to resolve the problems mentioned above by giving the bankruptcy court, in effect, the authority to determine whether the tax liability issue should be decided in the bankruptcy court or in the U.S. Tax Court.

Under new 11 U.S. Code section 362(a)(8), commencement of a bankruptcy case triggers an automatic stay of institution or continuation of any U.S. Tax Court proceedings to challenge an asserted tax deficiency of the debtor. Also under the new law, in order to maintain orderly judicial proceedings in any situation where a controversy might arise between a taxpayer and the Internal Revenue Service, assessment or collection of a prepetition tax claim against the debtor is automatically stayed by commencement of the bankruptcy case (sec. 362(a)(6)).[58] Unless the stay is lifted by the bankruptcy court, or a discharge is granted or denied, the stay continues until termination of the bankruptcy case (sec. 362(c)).

The new statute authorizes the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired) or to continue a pending Tax Court case involving the debtor's tax liability (new 11 U.S. Code sec. 362(d)). The bankruptcy court, for example, could lift the stay if the debtor seeks to litigate in the Tax Court and the trustee wishes to intervene in that proceeding. In such a case, the merits of the tax controversy will be determined by the Tax Court, and the Tax Court's decision will bind both the individual debtor as to any taxes which are nondischargeable and the intervenor trustee as to the tax claim against the estate.

However, if the bankruptcy court does not lift the automatic stay, but instead itself decides the tax issue and (at the request of the Revenue Service or of the debtor) determines the debtor's personal liability for a nondischargeable tax, then the bankruptcy court's decision will bind both the individual debtor and the estate as well as the government.[59]

Reasons for Change

The committee believes that the provisions of the Internal Revenue Code relating to assessment and collection procedures should be coordinated with rules enacted in the new bankruptcy statute (P.L. 95-598) for determination of tax liabilities in bankruptcy cases.

Explanation of Provisions

Sections 6(a), 6(b), 6(c), 6(d), and 6(g) of the bill coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95-598, as described above. These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court. These provisions are the same as the corresponding sections of the House bill.

Immediate assessment

General rule

Section 6(g) of the bill generally repeals the present rule (in sec. 6871(a) of the Code) authorizing the Internal Revenue Service to assess certain prepetition tax deficiencies of the debtor immediately on institution of bankruptcy proceedings. Accordingly, if the bankruptcy court lifts the automatic stay under new 11 U.S. Code section 362(a)(8), the debtor is not precluded from filing a petition (if timely) in the Tax Court to challenge an asserted prebankruptcy tax deficiency.

Exceptions

The bill authorizes the Revenue Service to make an immediate assessment (1) of tax imposed on the bankruptcy estate of an individual debtor, or (2) of tax imposed on a debtor if liability for such tax has become res judicata against the debtor pursuant to a bankruptcy court determination.

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[58] The stay does not preclude the Internal Revenue Service from issuing a deficiency notice during the bankruptcy case (new 11 U.S. Code sec. 362(b)(8)).

[59] 124 Cong. Rec. H-11, 111 (daily ed. Sept. 28, 1978) (remarks of Mr. Edwards); 124 Cong. Rec. S-17, 427 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). In the case of a corporate debtor, the commencement of a bankruptcy proceeding does not create a separate taxable entity, and (unlike in the case of an individual debtor) the debtor corporation is considered to be personally before the bankruptcy court. Accordingly, a decision by the bankruptcy court as to the corporate debtor's prepetition income tax liability is binding on the corporation, which cannot thereafter institute a Tax Court case to relitigate the issue. However, under P.L. 95-598, the bankruptcy judge is authorized to lift the automatic stay under new 11 U.S. Code sec. 362 and permit the tax issue to be determined in the U.S. Tax Court (if a case involving the issue is already pending in that Court, or if a deficiency notice has been issued and the period for filing such case has not expired).

These two exceptions reflect bankruptcy situations in which there is no need to require the Revenue Service to follow the normal deficiency notice procedure. In the case of taxes imposed on the bankruptcy estate of an individual (i.e., where the estate is treated as a separate taxable entity), the estate's own tax liability is determined by the bankruptcy court and cannot be litigated in the Tax Court. In the case where an individual debtor's personal liability for nondischargeable tax claims has been litigated in the bankruptcy court, and under the doctrine of res judicata the debtor would be precluded from relitigating the issue in any court, no purpose would be served by requiring issuance of a deficiency notice prior to assessment. For the same reason, the bill permits immediate assessment of a corporate debtor's tax liabilities once the bankruptcy court has made a determination which is res judicata.

Conforming rules

The bill also amends section 6871 of the Code to delete the prohibition in current law on filing a Tax Court petition after commencement of a bankruptcy proceeding. This change likewise conforms to the provisions of P.L. 95-598 which stay the debtor, on commencement of a bankruptcy case, from instituting a Tax Court proceeding to challenge an asserted tax deficiency, but authorize the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired). Also, the bill restates the rule of present law that claims for certain tax deficiencies, etc. may be presented for adjudication before the bankruptcy court, notwithstanding the pendency of any Tax Court proceedings for redetermination of the deficiency.

Receiverships

The bill does not modify the present law rules in section 6871 of the Code relating to receivership proceedings. To the extent immediate assessment authority is retained for receivership proceedings, and for the two bankruptcy situations described above, the bill expands the category of taxes which could be so assessed to include taxes under Internal Revenue Code chapters 41 (public charities), 42 (private foundations and black lung benefit trusts), 43 (qualified pension, etc., plans), 44 (real estate investment trusts), and 45 (windfall profit tax).

Collection

Section 6(g) of the bill amends section 6873(a) of the Code to delete the rule that any portion of a claim for nondischargeable taxes allowed in a bankruptcy case but not satisfied out of assets in the estate must be paid by the taxpayer upon notice and demand by the Internal Revenue Service after termination of the bankruptcy case. (No change is made in section 6873 with respect to payment of claims for taxes allowed in a receivership proceeding.) As described above, if the bankruptcy court has made a determination of the debtor's tax liability which (under the doctrine of res judicata) precludes the debtor from relitigating the issue in any other court, the Revenue Service can make an immediate assessment of such liability without issuing a deficiency notice. Thereafter, the provisions of the Code relating to collection of assessed taxes apply.

Tax Court petition

Section 6(b) of the bill provides that if the stay under new 11 U.S. Code section 362(a)(8) precludes a debtor from filing a petition in the U.S. Tax Court after receipt of a deficiency notice, the running of the normal 90-day period for filing the petition is suspended during the stay and for 60 days thereafter. Also, the bill clarifies that the filing of a proof of claim, the filing of request for payment, or other action taken by the Internal Revenue Service in the bankruptcy case (such as a request that the court determine the personal liability of an individual debtor for a nondischargeable tax) is not to be treated as prohibited under section 6213(a) of the Code (relating to certain restrictions generally applicable to assessment of a tax deficiency).

Tax Court intervention

Section 6(c) of the bill provides that the trustee of the bankruptcy estate of a debtor may intervene, as a matter of right, on behalf of the estate in any proceeding before the U.S. Tax Court to which the debtor is a party. This provision applies where the bankruptcy judge lifts the automatic stay under new 11 U.S. Code section 362 so that the debtor's prepetition tax liability can be determined in the Tax Court.

Assessment and collection limitations

Section 6(a) of the bill provides that if the automatic stay under the Internal Revenue Service is prohibited for a period of time by reason of a bankruptcy case from assessment or collection of tax (for example, because of the automatic stay under new 11 U.S. Code sec. 362(a)(6)), the running of

the period of limitations is suspended, for assessment, for the prohibition period and for 60 days thereafter; and for collection, for the prohibition period and for six months thereafter.

Cross references

Section 6(d) of the bill adds cross references in sections 6212, 6512, 6532, and 7430 of the Code to new 11 U.S. Code section 505 (relating to jurisdiction of the bankruptcy court).

2. Relief from certain failures to pay tax when due (sec. 6(e) of the bill and new sec. 6658 of the Code)

Present Law

The Internal Revenue Code (secs. 6651, 6654, and 6655) imposes penalties for failure timely to pay certain taxes, unless the taxpayer can establish that the failure was due to reasonable cause and not due to willful neglect. Under bankruptcy rules, a debtor or the trustee of a bankruptcy estate may be precluded from timely paying certain taxes after commencement of the bankruptcy proceedings.

Reasons for Change

The committee believes that penalties should not be imposed for failure timely to pay certain taxes to the extent that bankruptcy proceedings preclude payment of such taxes when due.

Explanation of Provision

Section 6(e) of the bill relieves the debtor or the trustee from penalties which otherwise might be applicable under sections 6651, 6654, or 6655 of the Code for failure timely to pay certain taxes, with respect to a period during which a bankruptcy case is pending, to the extent that the bankruptcy case precludes payment of such taxes when due.[60] This provision is the same as section 6(e) of the House bill.

In the case of a tax incurred by the estate, the relief is granted if the failure occurs pursuant to a court order finding probable insufficiency of funds to pay such taxes. In the case of a tax incurred by the debtor before commencement of the bankruptcy case, the relief provision of the bill applies if either the bankruptcy petition is filed before the tax return due date, or the date for imposing the penalty occurs after commencement of the bankruptcy case.

These relief rules do not, however, apply with respect to liability for penalties for failure timely to pay or deposit any employment tax required to be withheld by the debtor or trustee.

3. Preservation of FUTA credit (sec. 6(f) of the bill and sec. 3302 of the Code)

Present Law

Present law provides a credit against the Federal unemployment tax imposed on an employer for amounts paid by the employer into a State unemployment compensation fund (sec. 3302 of the Internal Revenue Code). A reduction in the otherwise allowable credit is required in the case of late contributions of a State fund (sec. 3302(a)(3) of the Code).

Reasons for Change

The committee believes that if because of the pendency of bankruptcy proceedings, the trustee of a bankruptcy estate is precluded from making timely payment of contributions to a State unemployment compensation fund, it is not appropriate to require a reduction in the credit against the Federal unemployment tax.

Explanation of Provision

Section 6(f) of the bill amends section 3302(a) of the Code to provide that there is no reduction in the credit against the FUTA tax if the failure to make timely contributions to a State unemployment compensation fund, with respect to wages paid by the trustee of a bankruptcy estate, is without fault of the trustee on account of the bankruptcy case. This provision is the same as section 6(f) of the House bill.

4. Repeal of deadwood provision (sec. 6(h) of the bill and sec. 1018 of the Code)

Present Law

Section 1018 of the Internal Revenue Code provides certain basis adjustment rules which apply if, in a bankruptcy proceeding under section 77B of the Bankruptcy Act which concluded before September 22, 1938, indebtedness was cancelled in pursuance of a plan of reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation.

[60] No inference is intended, by virtue of adoption of the rules in section 6(e) of the bill, that under present law such penalties should be imposed where a debtor or the trustee of a bankruptcy estate is precluded from timely paying such taxes by virtue of bankruptcy proceedings.

Reasons for Change

The committee believes that inasmuch as section 1018 of the Code applies only with respect to certain bankruptcy proceedings concluded before September 22, 1938, that provision should be deleted from the statute as deadwood.

Explanation of Provision

Section 6(h) of the bill repeals section 1018 of the Internal Revenue Code. This provision is the same as section 6(h) of the House bill.

5. Technical and conforming amendments (sec. 6(i) of the bill)

Section 6(i) of the bill makes technical and conforming amendments to the Internal Revenue Code, principally to substitute references to bankruptcy cases under new title 11 of the U.S. Code for references to bankruptcy proceedings under the now-repealed Bankruptcy Act.

1. Amendment of section 128(a). In section 128(a) of the Code, relating to cross references to other Acts, the reference to the Bankruptcy Act is deleted.

2. Amendment of section 354(c). Section 354(c) of the Code, relating to exchanges of stock and securities in certain railroad reorganizations, is amended to substitute a reference to plans of reorganization confirmed under new 11 U.S. Code section 1173, for a reference to plans approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act.

3. Amendment of section 422(c). Section 422(c)(5) of the Code, relating to certain transfers by insolvent individuals of stock acquired pursuant to exercise of a qualified stock option, is amended by substituting a reference to new 11 U.S. Code for a reference to the Bankruptcy Act.

4. Amendment of section 1023. Section 1023 of the Code, relating to cross references, is amended by deleting a cross reference to the Bankruptcy Act.

5. Amendment of section 6012(b). Section 6012(b)(3) of the Code, relating to returns made by receivers, trustees, and assignees for corporations, is amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

6. Amendment of section 6036. Section 6036 of the Code, relating to notice of qualification as executor or receiver, is amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

7. Amendment of section 6155(b). Section 6155(b)(2) of the Code, relating to cross references, is amended by deleting the reference to section 6873 of the Code with respect to bankruptcy proceedings (under the Bankruptcy Act).

8. Amendment of section 6161(c). Section 6161(c) of the Code, relating to extension of time for payment of tax claims in bankruptcy or receivership proceedings, is amended by substituting references to bankruptcy cases under new 11 U.S. Code for references to bankruptcy proceedings (under the Bankruptcy Act).

9. Amendment of section 6216(1). Section 6216(1), relating to cross references, is amended by deleting a reference to subchapter B of chapter 70 of the Code with respect to bankruptcy procedures.

10. Amendment of section 6326. Section 6326 of the Code, relating to cross references, is amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

11. Amendment of section 6503(i). Section 6503(i)(2), relating to cross references, is amended by deleting a reference to subchapter C of chapter 70 of the Code with respect to suspension of running a period of limitation in a bankruptcy proceeding (under the Bankruptcy Act).

12. Amendment of section 6872. Section 6872 of the Code, relating to suspension of period on assessment, is amended by substituting a reference to a bankruptcy case under new 11 U.S. Code for a reference to a bankruptcy proceeding under the Bankruptcy Act.

13. Amendment of section 7430. Section 7430 of the Code, relating to cross references, is amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

14. Amendment of section 7508(d). Section 7508(d)(1) of the Code, relating to time for performing certain acts postponed by reason of service in combat zone, is amended by substituting a reference to bankruptcy cases under new 11 U.S. Code for a reference to bankruptcy proceedings (under the Bankruptcy Act).

6. Effective date for provisions of section 6 of the bill

The provisions of section 6 of the bill (relating to changes in tax procedures) are effective October 1, 1979, except that such provisions do not apply to any Bankruptcy Act proceeding commenced before October 1, 1979.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL AS AMENDED

Budget Effect

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the effect on the budget of this bill, H.R. 5043, as amended.

The revenue effect of the provisions of the bill, other than of those provisions of section 2 (tax treatment of discharge of indebtedness) which apply to solvent taxpayers outside bankruptcy, cannot be estimated with precision. However, it is estimated that the provisions of section 2 other than those applicable to solvent taxpayers outside bankruptcy will result in some revenue gain; that the provisions of section 3 (rules relating to title 11 cases for individuals) and of section 6 (changes in tax procedures) will have a negligible revenue effect; and that the provisions of sections 4 and 5 (corporate reorganization provisions and miscellaneous corporate amendments) will result in some revenue loss.

It is not expected that these revenue effects will be significant during the next few fiscal years. This is because the provisions of the bill generally apply only to bankruptcy cases or similar court proceedings beginning after December 31, 1980, to transactions occurring more than 90 days after the date of enactment, or to transactions occurring after December 31, 1980; because it can take considerable time for completion of bankruptcy cases or similar proceedings and of corporate insolvency reorganizations; and because the debt discharge rules of the bill generally will affect revenues in years subsequent to the year in which the debt discharge occurs.

It is estimated that those provisions of section 2 of the bill which apply to solvent taxpayers outside bankruptcy, and which modify the election under sections 108 and 1017 of the Code to reduce basis of assets in lieu of recognizing income from discharge of indebtedness, will increase tax revenues by less than $5 million annually.

The Treasury Department agrees with this statement.

New Budget Authority and Tax Expenditures

In accordance with section 308 of the Budget Act, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new or increased budget authority or new or increased tax expenditures.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated above) and agrees with the methodology used and the resulting revenue estimates.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 5043, as amended, was ordered favorably reported by voice vote.

IV. REGULATORY IMPACT OF THE BILL

In compliance with paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the following statement is made regarding the provisions of this bill, H.R. 5043, as reported by the committee.

Individuals and businesses regulated and economic impact of regulation. The bill does not regulate any individuals or businesses, but modifies certain provisions of the tax law principally relating to the treatment of discharge of indebtedness (inside and outside bankruptcy), insolvency reorganizations, the bankruptcy estate of an individual debtor, and tax assessment and collection procedures in bankruptcy cases.

Impact on personal privacy. The provisions of the bill will have minimal impact on personal privacy.

Determination of paperwork involved. The provisions of the bill will have minimal impact on paperwork.

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, H.R. 5043, as reported by the committee).

APPENDIX C

Senate Proposed Amendments to H.R. 5043 (Bankruptcy Tax Act of 1980) Adopted by Both Senate and House

Congressional Record—Senate, December 13, 1980, S16489-S16493

BANKRUPTCY TAX ACT OF 1980

Mr. ROBERT C. BYRD. Mr. President, I ask unanimous consent that the Senate proceed to the consideration of H.R. 5043, Calendar No. 1167.

There being no objection,

The Senate proceeded to consider the bill (H.R. 5043) to amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes, which had been reported from the Committee on Finance with amendments, as follows:

On page 5, after line 4, insert the following:

(E) FOREIGN TAX CREDIT CARRYOVERS.—Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 33.

On page 5, line 16, strike "paragraph (2)(B)" and insert the following: "subparagraphs (B) and (E) of paragraph (2)";

On page 6, line 9, strike "SUBPARAGRAPH (B)" and insert the following: "SUBPARAGRAPHS (B) AND (E) OF PARAGRAPH (2)";

On page 6, line 15, strike "depreciable property" and insert the following: "the depreciable property";

On page 9, after line 7, insert the following:

(5) DEPRECIABLE PROPERTY.—The term 'depreciable property' has the same meaning as when used in section 1017.

On page 9, line 11, strike "(5)" and insert "(6)";

On page 9, line 15, strike "(6)" and insert "(7)";

On page 9, line 24, strike "(7)" and insert "(8)";

On page 10, line 14, strike "(8)" and insert "(9)";

On page 11, line 20, after the period, insert the following: Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

On page 12, line 11, strike "section 414(e)" and insert the following: "subsection (b) or (c) or section 414";

On page 13, strike line 6, through and including page 15, line, and insert the following:

(6) INDEBTEDNESS CONTRIBUTED TO CAPITAL.—For purposes of determining income of the debtor from discharge, 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.

(7) Recapture of gain on subsequent sale of stock.—

(A) IN GENERAL.—If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245—

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property, and

(ii) the aggregate amount allowed to the creditor—

(I) as deductions under subsection (a), (b), or (c) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange, shall be treated as an amount allowed as a deduction for depreciation.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) TAXPAYERS ON RESERVE METHOD.—In the case of a taxpayer to whom subsection (c) of section 166 (relating to reserve for bad debts) applies, the amount determined under clause (ii) of subparagraph (A) shall be the aggregate charges to the reserve resulting from the worthlessness or partial worthlessness of the indebtedness.

(C) SPECIAL RULE FOR CASH BASIS TAXPAYERS.—In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness has been satisfied in full.

(D) STOCK OF PARENT CORPORATION.—For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(E) TREATMENT OF SUCCESSOR CORPORATION.—For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(F) PARTNERSHIP RULE.—Under regulations prescribed by the Secretary, rules similar to the rules of subparagraphs (A), (B), (C), (D), and (E) of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) STOCK FOR DEBT EXCEPTION NOT TO APPLY IN DE MINIMIS CASES.—For purposes of determining income of the debtor from discharge of indebtedness, the stock for debt exception shall not apply—

(A) to the issuance of nominal or token shares, or

(B) with respect to an unsecured creditor, where the ratio of the value of the stock received by such unsecured creditor to the amount of his indebtedness cancelled or exchanged for stock in the workout is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout.

(9) DISCHARGE OF INDEBTEDNESS INCOME NOT TAKEN INTO ACCOUNT IN DETERMINING WHETHER ENTITY MEETS REIT QUALIFICATION.—Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

On page 20, line 25, strike "Any interest" and insert the following: "For purposes of this section, any interest"

On page 21, after line 4, insert the following: The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.

(D) SPECIAL RULE IN CASE OF AFFILIATED GROUP.—For purposes of this section, if—

(i) a corporation holds stock in another corporation (hereinafter in this subparagraph referred to as the 'subsidiary'), and

(ii) such corporations are members of the same affiliated group which file a consolidated return under section 1501 for the taxable year in which the discharge occurs, then such stock shall be treated as depreciable property to the extent that such subsidiary consents to a corresponding reduction in the basis of its depreciable property.

(E) ELECTION TO TREAT CERTAIN INVENTORY AS DEPRECIABLE PROPERTY.—

(i) IN GENERAL.—At the election of the taxpayer, for purposes of this section, the term depreciable property includes any real property which is described in section 1221 (1).

(ii) ELECTION.—An election under clause (i) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary. Such an election, once made, may be revoked only with the consent of the Secretary.

On page 22, strike line 20 through and including page 23, line 2;

On page 23, line 3, strike "(3)" and insert "(2)";

On page 23, strike line 8, through and including line 13, and insert the following:

(1) IN GENERAL.—For purposes of sections 1245 and 1250—

(A) any property the basis of which is reduced under this section and which is neither section 1245 property nor section 1250 property shall be treated as section 1245 property, and

On page 24, strike line 11, through and including page 25, line 7, and insert the following:

(d) AMENDMENT OF SECTION 382(b).—Subsection (b) of section 382 (relating to special limitations on net operating loss carryover), as in effect before its amendment by section 806 of the Tax Reform Act of 1976, is amended by adding at the end thereof the following new paragraph:

(7) SPECIAL RULE FOR REORGANIZATIONS IN TITLE 11 OR SIMILAR CASES.—For purposes of this subsection, a creditor who receives stock in a reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) shall be treated as a stockholder immediately before the reorganization.

On page 26, between lines 13 and 14, strike "108(f) (1)(B)" and insert "108(e)(6)";

On page 26, strike line 14, through and including the material between lines 16 and 17;

On page 28, strike line 16 through and including line 24, and insert the following:

(d) TAXABLE YEARS OF DEBTORS—

(1) GENERAL RULE.—Except as provided in paragraph (2), the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.

On page 29, line 5, strike "(3)" and insert "(2)";

On page 30, line 19, strike "(4)" and insert "(3)";

On page 30, strike line 24, through and including the material prior to line 1 on page 31;

On page 31, line 7, after the period, insert the following:

The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date (as defined in subsection (d)(3)).

On page 31, strike line 16 through and including line 20;

On page 31, line 21, strike "(4)" and insert "(3)";

On page 32, line 13, strike "transfer" and insert "DISPOSITION";

On page 32, line 15, strike "transfer" and insert "disposition";

On page 32, line 17, strike "transfer" and insert "disposition";

On page 32, line 21, strike "TRANSFER" and insert "DISPOSITION";

On page 32, line 24, strike "transfer" and insert "disposition";

On page 33, line 1, strike "transfer" and insert "disposition";

On page 51, strike line 22, through and including page 53, line 2, and insert the following:

(g) TITLE 11 OR SIMILAR CASES.—If a corporation completely liquidates pursuant to a plan of complete liquidation adopted in a title 11 or similar case (within the meaning of section 368()a(3)(A))—

(1) for purposes of subsection (a), the term 'property' shall not include any item acquired on or after the date of the adoption of the plan of liquidation if such item is not property within the meaning of subsection (b)(2), and

(2) subsection (a) shall apply to sales and exchanges by the corporation of property within the period beginning on the date of the adoption of the plan and ending on the date of the termination of the case.

On page 55, line 1, strike "exchange is" and insert "exchange are";

On page 55, strike line 5, through and including line 11, and insert the following:

(f) EFFECT ON EARNINGS AND PROFITS.—Section 312 (relating to effect on earnings and profits) is amended by adding at the end thereof the following new subsection:

(1) DISCHARGE OF INDEBTEDNESS INCOME.

(1) DOES NOT INCREASE EARNINGS AND PROFITS IF APPLIED TO REDUCE BASIS.—The earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017.

(2) Reduction of Deficit in earnings and profits in certain cases.—If—

(A) the interest of any shareholder of a corporation is terminated or extinguished in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), and

(B) there is a deficit in the earnings and profits of the corporation, then such deficit shall be reduced by an amount equal to the paid-in capital which is allocable to the interest of the shareholder which is so terminated or extinguished".

On page 56, strike line 24, through and including page 57, line 4, and insert the following:

(b) Coordination of Deficiency Procedures with Title 11 Cases.—

(1) GENERAL.—Section 6213 (relating to restrictions applicable to deficiencies; petition to Tax Court) is amended by redesignating subsections (f) and (g) as subsections (g) and (h), respectively, and by inserting after subsection (e) the following new subsection:

On page 58, after line 4, insert the following:

(2) CLERICAL AMENDMENT.—Subsection (d) of section 6404 (relating to abatement) is amended by striking out "section 6213(f)(2)(A)" and inserting in lieu thereof "section 6213(g)(2)(A)."

On page 68, in the material between lines 3 and 4, strike "554" and insert "545";

On page 68, strike line 9, through and including page 71, line 16, and insert the following:

SEC. 7. EFFECTIVE DATES.

(a) FOR SECTION 2 (RELATING TO TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS).—The amendments made by section 2 shall apply to any transaction which occurs after December 31, 1980, other than a transaction which occurs in a proceeding in a bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commencing on or before December 31, 1980.

(b) FOR SECTION 3 (RELATION TO RULES RELATING TO TITLE 11 CASES FOR INDIVIDUALS).—The amendments made by section 3 shall apply to any bankruptcy case commencing more than 90 days after the date of the enactment of this Act.

(c) FOR SECTION 4 (RELATING TO CORPORATE REORGANIZATION PROVISIONS).—

(1) IN GENERAL.—The amendments made by section 4 shall apply to any bankruptcy case or similar judicial proceeding commencing after December 31, 1980.

(2) EXCHANGES OF PROPERTY FOR ACCRUED INTEREST.—The amendments made by subsection (e) of section 4 (relating to treatment of property attributable to accrued interest) shall also apply to any exchange—

(A) which occurs after December 31, 1980, and

(B) which does not occur in a bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commenced on or before December 31, 1980.

(d) FOR SECTION E (RELATING TO MISCELLANEOUS CORPORATE AMENDMENTS.)—

(1) FOR SUBSECTION (A) (RELATING TO EXEMPTION FROM PERSONAL HOLDING COMPANY TAX.)—The amendments made by subsection (a) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(2) FOR SUBSECTION (B) (RELATING TO REPEAL OF SPECIAL TREATMENT FOR CERTAIN RAILROAD REDEMPTIONS).—The amendments made by subsection (b) of section 5 shall apply to stock which is issued after December 31, 1980 (other than stock issued pursuant to a plan of reorganization approved on or before that date).

(3) FOR SUBSECTION (C) (RELATING TO APPLICATION OF 12-MONTH LIQUIDATION RULE).—The amendment made by subsection (c) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(4) FOR SUBSECTION (D) (RELATING TO PERMITTING BANKRUPTCY ESTATE TO BE SUBCHAPTER'S SHAREHOLDER).—The amendment made by section (d) of section 5 shall apply to any bankruptcy case commenced on or after October 1, 1979.

(5) FOR SUBSECTION (E) (RELATING TO CERTAIN TRANSFERS TO CONTROLLED CORPORATIONS).—The amendments made by subsection (e) of section 5 shall apply as provided in subsection (a) of this section.

(6) FOR SUBSECTION (F) (RELATING TO EFFECT OF DEBT DISCHARGE ON EARNINGS AND PROFITS).—The amendment made by subsection (f) of section 5 shall apply as provided in subsection (a) of this section.

(e) FOR SECTION 6 (RELATING TO CHANGES IN TAX PROCEDURES).—The amendments made by section 6 shall take effect on October 1, 1979, but shall not apply to any proceeding under the Bankruptcy Act commenced before October 1, 1979.

(f) ELECTION TO SUBSTITUTE SEPTEMBER 30, 1979, FOR DECEMBER 31, 1980.—

(1) IN GENERAL.—The debtor (or debtors) in a bankruptcy case or similar judicial proceeding may (with the approval of the court) elect to apply subsections (a), (c), and (d) by substituting "September 30, 1979" for "December 31, 1980" each place it appears in such subsections.

(2) EFFECT OF ELECTION.—Any election made under paragraph (1) with respect to any proceeding shall apply to all parties to the proceeding.

(3) REVOCATION ONLY WITH CONSENT.—Any election under this subsection may be revoked only with the consent of the Secretary of Treasury or his delegate.

(4) TIME AND MANNER OF ELECTION.—Any election under this subsection shall be made at such time, and in such manner, as the Secretary of the Treasury or his delegate may by regulations prescribe.

(g) DEFINITIONS.—For purposes of this section—

(1) BANKRUPTCY CASE.—The term "bankruptcy case" means any case under title 11 of the United States Code (as recodified by Public Law 95-598).

(2) SIMILAR JUDICIAL PROCEEDING.—The term "similar judicial proceeding" means a receivership, foreclosure, or similar proceeding in a Federal or State court (as modified by section 368(a)(3)(D) of the Internal Revenue Code of 1954).

• Mr. LONG. Mr. President, H.R. 5043, the Bankruptcy Tax Act of 1980, deals with the Federal income tax aspects of bankruptcy, insolvency, and discharge of indebtedness.

This important bill has been carefully developed over the past 2 years on the basis of extensive hearings and in close consultation with bar association groups, accounting groups, bankruptcy attorneys, and others. The American Bar Association tax section, the American Institute of Certified Public Accountants, the New York City Bar Tax Committee, and other groups strongly support enactment this year of bankruptcy tax legislation.

Unless this bill is enacted this year, there will be a statutory void as to the tax treatment of discharge of debt in bankruptcy. This is because the 1978 bankruptcy statute (Public Law 95-598) repealed provisions of the old Bankruptcy Act which had contained rules for tax treatment of debt discharge in bankruptcy. In addition, Internal Revenue Code provisions on insolvency reorganizations and other topics now refer to repealed provisions of the old Bankruptcy Act. These Code provisions will be the subject of confusion and controversy, and other Code provisions will conflict with procedural rules in the new bankruptcy law, unless this legislation is enacted.

The development of bankruptcy tax legislation began with the 1973 report issued by the Commission on Bankruptcy Laws, established by the Congress. That report recommended changes and clarifications in both substantive rules and tax rules of bankruptcy. The House Judiciary Committee held hearings and likewise made recommendations for modifying the tax rules of bankruptcy, including recommendations for applying the amount of debt discharge to reduce net operating losses.

In 1978, the 95th Congress enacted legislation to revise and modernize the substantive law of bankruptcy as well as bankruptcy court procedures. During both the 95th Congress and this Congress, the tax committees held hearings on the recommendations for modifying and clarifying the tax rules of bankruptcy. H.R. 5043 now completes the process of revising and modernizing Federal bankruptcy laws by providing rules governing the tax aspects of bankruptcy.

Mr. President, I now want to briefly summarize the amendments made by the Senate Finance Committee to the House bill. First, the committee bill generally returns to the present law rule developed by the courts that no income is recognized and no attribute reduction is required if a corporation issues its stock to creditors in cancellation of outstanding debt. The committee believes that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill will encourage reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.

Second, the Finance Committee also modified the effective date provisions of H.R. 5043. Under the committee bill, the provisions relating to debt discharge in bankruptcy, tax-free bankruptcy reorganizations, and certain miscellaneous corporate amendments will apply to bankruptcy cases beginning after December 31, 1980.

Mr. President, I urge the adoption of H.R. 5043 as reported by the Finance Committee.

The following is a more detailed description of the amendments made by the Senate Finance Committee to the House bill.

The Committee agreed to amend certain rules in the House bill with respect to the income tax treatment of discharge of indebtedness. The House bill provided that if a corporation issues stock in cancellation of short-term debt or trade credit, the corporate debtor would be required to reduce tax attributes by an amount equal to the excess of the indebtedness over the value of the stock. Under the Committee amendment, no income would be recognized and no attribute reduction would be required when stock is issued for outstanding debt, whether or not the debt constitutes a "security" for tax purposes. Therefore, no tax consequences would result to the debtor on issuance of stock worth less than the face amount of the obligation satisfied. This stock-for-debt rule under the amendment would not apply if only a *de minimis* amount of stock is issued for the outstanding debt.

The amendment also changes rules of the House bill with respect to issuance of a package of stock and other property in cancellation of debt. Under the House bill, the stock would be treated as issued for a proportion of the debt equal to its proportion of the value of the total consideration. Under the amendment, the cash or other property would be treated as satisfying an equal amount of debt, and the stock as satisfying the remainder of the debt. Consequently, there would be no tax consequences to the debtor (subject to the *de minimis* exception stated above).

The amendment also provides that if a creditor receiving stock for debt has taken an ordinary bad debt deduction, any gain on a later sale of the stock by the creditor would be "recaptured" as ordinary income up to the amount of the creditor's prior deduction against income.

Under the Committee amendment, the provision of the House bill excepting stock for debt exchanges in a bankruptcy or similar case from Code Section 382(a) would be deleted.

The Committee also amended certain effective date provisions of the House bill. Specifically, under the House bill, the provisions relating to tax treatment of debt discharge (section 2), corporate reorganizations in bankruptcy (section 4), and certain miscellaneous corporate amendments (section 5) would apply for bankruptcy (section 4), and certain miscellaneous corporate amendments (section 5) would apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979.

Under the amendment, the provisions of sections 2, 4, and 5 of the bill would apply to bankruptcy cases (or receivership, etc. proceedings) commenced after December 31, 1980. However, some taxpayers may have entered into bankruptcy reorganizations with the expectation that the bill would be enacted with the original retroactive effective dates. Accordingly, the amendment allows a bankrupt or insolvent debtor to elect to have all the debt discharge and related provisions of the bill apply retroactively (in the case of proceedings commenced on or after October 1, 1979).

In the case of transactions outside bankruptcy (or receiverships, etc.), the rules of the bill generally would apply to transactions after December 31, 1980, and the amendment does not change this provision.

The Committee also adopted the following technical and clarifying amendments to the House bill.

SECTION 2 (TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS)

1. Election to reduce basis in depreciable assets held by certain subsidiaries (modification to sec. 2(b) of the bill, amending Code sec. 1017):

Under the House-passed bill, a debtor in bankruptcy or an insolvent debtor could elect to apply the amount of discharged debt first to reduce basis in depreciable property, before applying any remaining amount to reduction of specified tax attributes. Similarly, a solvent debtor outside bankruptcy could elect to reduce basis in depreciable assets instead of recognizing current income from debt cancellation. To insure that ordinary income treatment eventually would be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" as ordinary income.

The amendment would expand these election provisions to provide also that if the debtor is a parent holding company which files a consolidated return with a subsidiary, the debtor could elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of the stock of the subsidiary to the extent the subsidiary consents to reduce the basis of its depreciable assets. The "recapture" rule stated above would apply to a disposition of the reduced-basis assets.

2. Election to reduce basis in realty held as inventory (modification to sec. 2(b) of the bill, amending Code sec. 1017):

The election provisions summarized in paragraph 1 above would be further expanded by the amendment to also allow application of the debt discharge amount to reduce basis in real property held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of Code sec. 1221(1)). To the extent the debtor elects to reduce basis in such realty, the particular

real properties the bases of which would be reduced are to be determined pursuant to Treasury regulations. A subsequent disposition of reduced-basis realty would result in recognition of a larger amount of ordinary income, just as reduction in basis of depreciable assets in lower depreciation deductions to offset ordinary income.

3. Discharge of partnership debt (modification to sec. 2(b) of the bill):

The House-passed bill provides that if a taxpayer must account for a debt discharge amount because indebtedness is cancelled, the taxpayer's interest in any partnership may be treated as depreciable property to the extent of his interest in depreciable property of the partnership. Under the bill, in the case of discharge of partnership debt, the partner could elect to reduce the basis of his partnership interest (in lieu of attribute reduction or income recognition) only if the partnership makes a corresponding reduction in the basis of depreciable assets of the partnership with respect to such partner.

The amendment would clarify that a partner's interest in any partnership (whether or not that partnership debt was discharged) may be treated as a depreciable asset only if the partnership makes a corresponding reduction in the basis of depreciable assets of the partnership with respect to such partner. Also, the amendment would state that the amount of reduction in the partner's basis in the partnership interest, and the particular depreciable assets of the partnership the bases of which are to be reduced, are to be determined pursuant to Treasury regulations.

4. Debt acquired by related parties (modification to sec. 2(a) of the bill, amending Code sec. 108):

The House-passed bill provides that, for purposes of the debt discharge rules, acquisition of a debt by a related party would be treated as acquisition by the debtor. The Ways and Means Committee report states that the income tax consequences of repayment or capital contribution of a debt which had been acquired by a related party are to be provided in Treasury regulations. The report further indicates that the tax consequences would include allowing the debtor a deduction equal to the amount of any gain or income recognized by the regulated party if the debt is repaid or contributed to capital (House Rep. 96-833, p. 16).

The related party rules in the bill would be amended to add a provision stating that the tax treatment of a repayment or a capital contribution of a debt which had been acquired by a related party would, pursuant to Treasury regulations, be substantially the same as if the debtor itself 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 subsidiary has a debt discharge amount of $100. If the subsidiary pays its parent the full principal amount ($1,000) when the debt matures, the Treasury regulations would treat the $100 difference as a dividend to the parent, against which the dividends received deduction would be available as provided by present law (Code sec. 243—246). The repayment would not have any tax consequences to the subsidiary. Likewise, if the debt were later cancelled, the parent would be treated as having contributed $900 to the subsidiary (with no tax consequences).

5. Reduction of certain credit carryovers on debt discharge in bankruptcy or insolvency (modification to sec. 2(a) of the bill, amending Code sec. 108):

Unless the taxpayer elects first to reduce basis in depreciable assets or in section 1221 (1) realty, the amount of debt discharge in bankruptcy (or in the case of an insolvent debtor) would be applied under the House-passed bill to reduce net operating losses or carryovers, carryovers of certain tax credits, capital losses and carryovers, and the basis of the taxpayer's assets. These provisions would be modified also to provide that if any debt discharge amount remains after reduction of such attributes (including any debt discharge amount which remains unapplied solely by virtue of the limitation in the bill with respect to basis reduction), such remaining amount would be applied to reduce carryovers of the foreign tax credit.

6. Real estate investment trusts (modification to sec. 2 of the bill):

To qualify as a real estate investment trust (REIT), an organization must satisfy, among other requirements, source-of-income tests establishing that it has primarily passive income from real estate investments (Code sec. 856). In light of the bill's rules governing the tax consequences of debt discharge, the amendment would add a provision specifying that income from cancellation of indebtedness is not to be taken into account for the source-of-income tests. For example, if a solvent REIT investing primarily in mortgages has debt cancellation on redemption of bonds, and such amount would be includible in gross income under the rules of the bill (absent an election to apply such amount to reduce the basis of depreciable assets), the amount of such income would not be taken into account for purposes of Code section 856.

7. Amendment to Code section 382(b) (modification of sec. 2(d) of the bill, amending Code sec. 382):

The House-passed bill provides that creditors of a debtor corporation would be treated as shareholders in applying the continuity rules of Code section 382(b) to a "G" reorganization. The amendment would extend this rule to apply to any reorganization in a bankruptcy or similar case, rather than solely in a "G" reorganization.

SECTION 3 (RULES RELATING TO TITLE CASES FOR INDIVIDUALS)

1. Taxable year of the estate (prop. Code sec. 1398(d)(1)):

The House-passed bill provides that the first taxable year of the bankruptcy estate of an individual debtor ends on the same day as the debtor's taxable year which includes the date on which the bankruptcy case commences. This rule has been developed as a part of a prior version of the bill, which would have required that the estate report certain income recognized prior to commencement of the case. Inasmuch as the bill has been changed and now permits the debtor to close his or her taxable year on commencement of the case, the rule relating to the estate's taxable year no longer is necessary and accordingly would be deleted by the amendment.

2. Estate's share of the debtor's income (prop. Code sec. 1398(e)(1)):

The House-passed bill provides that the gross income of the bankruptcy estate of an individual debtor would include any gross income of the debtor to which the estate is entitled under bankruptcy law. The amendment would clarify that only such income which is recognized after commencement of the case would be includible in the estate's gross income.

3. Allocation of deductions and credits (prop. Code sec. 1398(e)(3)):

In cases where the bankruptcy estate of an individual would be treated as a separate taxable entity, the House-passed bill provides rules for allocating deductions and credits between the debtor and the estate. The amendment would modify these rules to make clear that only those expenses paid or accrued by the debtor which are not properly allowable to the debtor would be allocated to the estate. For example, an expense paid by a cash basis debtor before commencement of the bankruptcy case would be allowed to the debtor, even if such deduction could be considered to be associated with income which is allocated to the estate under the rules of the bill. Also, an expense paid or accrued by the debtor after commencement of the bankruptcy case would be allocated to the debtor, and not to the estate.

4. No-disposition rules (prop. Code sec. 1398(f)):

The bill provides that a transfer (other than by sale or exchange) of an asset from an individual debtor to the bankruptcy estate, or from the bankruptcy estate to the debtor on termination of the estate, would not be treated as a "transfer" giving rise to recognition of gain or loss, recapture of deductions, or acceleration of income or deductions. To conform with language used in related Code provisions, these provisions would be modified to provide that such a transfer would not be treated as a "disposition" for tax purposes.

5. Carryover of attributes to debtors (prop. Code sec. 1398(i)):

The bill provides that on termination of a bankruptcy estate, the debtor would succeed to various tax attributes of the estate. This provision would be modified to make clear that the carryover includes attributes first arising during administration of the estate (other than the new administrative expense deduction which would be provided under the bill).

SECTION 5 (MISCELLANEOUS CORPORATE AMENDMENTS)

1. Application of section 337 liquidation rule to insolvent corporations (modification to sec. 5(c) of the bill, amending Code sec. 337):

The House bill expands the nonrecognition provisions under Code section 337 to allow a liquidating corporation in a bankruptcy or similar case generally to sell its assets taxfree during the entire duration of the proceeding. The amendments would make this provision applicable whether or not any shareholder receives any consideration for his stock and also would clarify that assets may be retained to pay administrative claims following the close of the case.

2. Effect of discharge of indebtedness on earnings and profits (modification of sec. 5(f) of the bill, amending Code sec. 312):

The House bill provides that to the extent income from discharge of indebtedness (including an amount excluded from gross income pursuant to Code section 108, as amended by the bill) is applied to reduce basis under Code section 1017, such basis-reduction amount does not affect the debtor corporation's earnings and profits. Otherwise, discharge of indebtedness income, including amounts excluded from gross income (pursuant to Code section 108, as amended by the bill), increases the earnings and profits of the corporation (or reduces a deficit). The amendment would

provide also that any deficit in earnings and profits would be reduced by the capital account of any shareholder whose interest is eliminated in a bankruptcy proceeding.•

• Mr. DOLE. Mr. President, the Bankruptcy Tax Act is the product of years of effort and addresses the needs and interests of debtors, creditors, and bankruptcy practitioners alike.

In 1978, Congress repealed the laws providing the income tax consequences involved when a creditor forgives indebtedness in a bankruptcy situation. Since that time, debtors and creditors, as well as their advisers, have had to live with uncertainty as to the tax consequences of their actions in attempting to restructure their rights and obligations. It is obviously very difficult to determine the real economic consequences of a transaction without knowing how it will be taxed.

PROVIDING CERTAINTY IN THE TAX LAWS

The Bankruptcy Tax Act will provide certain and balanced tax rules for treatment of debt discharge in the case of bankrupt or insolvent debtors and make coordinating changes in the rules for cancellation of indebtedness in the case of solvent taxpayers. The legislation also clarifies the tax rules governing insolvency reorganizations for corporations and the bankruptcy estate of individual debtors. It also makes other changes in administrative provisions of the tax laws to coordinate with the substantive bankruptcy law changes enacted in 1978.

This legislation represents a much needed package of technical amendments to the income tax laws in a very sensitive part of the economy. Astronomical interest rates and inflation are placing great strain on many taxpayers who are being forced into bankruptcy.

FINANCE COMMITTEE PRO-DEBTOR AMENDMENT

The Finance Committee, however, was concerned that the legislation as referred to the committee was not balanced sufficiently to allow debtors to reorganize and survive economic distress. We, therefore, amended certain rules relating to the exchange of debt for stock of the debtor. Under the committee amendment, a debtor corporation will neither recognize income, nor will be required to reduce tax attributes such as net operating loss carryovers when it issues its stock to a creditor in exchange for outstanding debt.

This amendment has been strongly supported by practitioners including the tax section of the American Bar Association. We expect that this provision will be very effective in helping financially distressed debtors to regain economic health and keep their employees from losing their jobs.

TIME FOR FINE TUNING NEXT YEAR

It may be necessary to fine tune other portions of this legislation to make sure that the tax laws facilitate, rather than hinder, the policies of the bankruptcy laws.

We must review the general rules relating to limitations on net operating loss carryovers in reorganization situations this coming year. As you know, the Congress enacted legislation to postpone the effective date of these limitations. This postponement ends December 31, 1981. It would, therefore, be appropriate to review the limitations on net operating loss carryovers in bankruptcy reorganization situations next year if it proves to be necessary.

In the meantime, this legislation provides much improvement in the tax laws and should be enacted without further delay. •

• Mr. ROBERT C. BYRD. Mr. President, I ask unanimous consent that a technical amendment to the bill be considered and agreed to; that an amendment by Mr. DeConcini delaying the effective date of one section be agreed to; that the measure be advanced to third reading, adopted, and a motion to reconsider be laid on the table.

Mr. CHAFEE. Mr. President, that is agreeable to this side.

The PRESIDING OFFICER. Is there objection to the unanimous-consent request of the majority leader?

Mr. ROBERT C. BYRD. With the reported committee amendment agreed to.

The PRESIDING OFFICER. Without objection, it is so ordered.

The amendment proposed by Mr. Long (UP No. 1929) is as follows:

(Purpose: Making technical corrections.)

On page 55, strike lines 8 through 11.

On page 58, strike lines 5 through 8, and insert in lieu thereof the following:

(2) CLERICAL AMENDMENT.—Subsection (d) of section 6404 (relating to abatements) is amended by striking out "section 6213(f)(2)(A)" and inserting in lieu thereof "section 6213(g)(2)(A)".

Mr. DeConcini's amendment (UP No. 1930) is as follows:

(Purpose: Relating to the effective date.)

On page 71, strike out lines 18 through 24, and insert in lieu thereof the following:

(a) FOR SECTION 2 (RELATING TO TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS).—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by section 2 shall apply to any transaction which occurs after December 31, 1980, other than a transaction which occurs in a proceeding in a bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commencing on or before December 31, 1980.

(2) TRANSITIONAL RULE.—In the case of any discharge of indebtedness to which subparagraph (A) or (B) of section 108(a)(1) of the Internal Revenue Code of 1954 (relating to exclusion from gross income), as amended by section 2, applies and which occurs before January 1, 1982, or which occurs in a proceeding in a bankruptcy case or similar judicial proceedings commencing before January 1, 1982, then—

(A) section 108(b)(2) of such Code (relating to reduction of tax attributes), as so amended, shall be applied without regard to subparagraphs (A), (B), (C), and (E) thereof, and

(B) the basis of any property shall not be reduced under section 1017 of such Code (relating to reduction in basis in connection with discharges of indebtedness), as so amended, below the fair market value of such property on the date the debt is discharged.

Mr. CHAFEE. Mr. President, I ask unanimous consent that Senator Wallop be added as a cosponsor to Mr. DeConcini's amendment.

The PRESIDING OFFICER. Without objection, it is so ordered.

• Mr. DeCONCINI. The amendment postpones for 1 year the requirement under the Finance Committee bill that a bankrupt or insolvent debtor must reduce net operating losses by the amount of debt discharge (or alternatively, must reduce basis in depreciable assets). Under the Finance Committee bill, this attribute reduction requirement generally would have applied to debt discharge occurring after December 31, 1980. Under the amendment, however, this attribute reduction requirement will not apply, in the case of a bankrupt or insolvent debtor, to debt discharge which occurs before January 1, 1982, or which occurs in a bankruptcy case or similar judicial proceeding beginning before January 1, 1982.

Thus, under the amendment, a bankrupt or insolvent debtor will apply the amount of debt discharge to reduce basis in assets in the case of a debt discharge to which the bill applies occurring before January 1, 1982, or occurring in a bankruptcy case or similar proceeding commencing before January 1, 1982.

Furthermore, such a debtor will not be required to reduce asset basis below fair market value. Under the amendment, any amount of debt discharge remaining after asset basis is so reduced will not have any tax consequences—that is, the remaining amount will not be included in income and will not result in reduction of net operating losses or other tax attributes.

Thus, in the case of debt discharge before 1982, or bankruptcy cases or similar judicial proceedings beginning before 1982, bankrupt or insolvent debtors will be subject to a basis reduction rule like that in the now repealed provisions of the Bankruptcy Act.

The rules of the Senate Finance bill not covered by this amendment will become effective as provided in the bill reported by the Finance Committee. For example, the rules providing that basis reduction does not trigger investment credit recapture tax (thereby overturning a contrary Internal Revenue Service ruling) and the rules relating to indebtedness acquired by a related party will become effective for transactions in bankruptcy cases which commence after December 31, 1980. As another example, the rules of the bill relating to tax-free insolvency reorganizations will become effective, as under the Finance Committee bill, for bankruptcy cases commencing after December 31, 1980. Also, in the case of solvent taxpayers outside bankruptcy, the attribute reduction rules of the Finance Committee bill will become effective for debt discharges occurring after December 31, 1980.

The postponement made by the amendment in the effective date of the attribute reduction requirements for bankrupt or insolvent debtors will permit the Congress to give due consideration to any additional comments that the public may wish to make concerning such requirements. •

APPENDIX D

Representative Ullman's Statement Regarding Bankruptcy Tax Legislation

CONGRESSIONAL RECORD—HOUSE, DECEMBER 12, 1980, H12419, H12420, H12459-H12464

REQUEST TO CONCUR IN SENATE AMENDMENTS TO H.R. 5043, BANKRUPTCY TAX ACT OF 1980

Mr. ROSTENKOWSKI. Mr. Speaker, I ask unanimous consent to take from the Speaker's table the bill (H.R. 5043) to amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes, with Senate amendments thereto, and concur in the Senate amendments.

The Clerk read that title of the bill.

The Clerk read the Senate amendments, as follows:

Page 4, after the matter below line 20, insert:

(E) FOREIGN TAX CREDIT CARRYOVERS.—Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 33.

Page 8, line 20, strike out "(5)" and insert "(6)".

Page 8, line 24, strike out "(6)" and insert "(7)".

Page 9, line 9, strike out "(7)" and insert "(8)".

Page 9, line 22, strike out "(8)" and insert "(9)".

Page 11, line 6, after "debtor," insert "Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence".

Page 11, line 17, strike out "section 414(c)" and insert "subsection (b) or (c) of section 414".

Page 12, strike out all after line 9, over to and including line 9 on page 14, and insert:

(6) INDEBTEDNESS CONTRIBUTED TO CAPITAL.—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.

(7) RECAPTURE OF GAIN ON SUBSEQUENT SALE OF STOCK.—

(A) IN GENERAL.—If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245—

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property, and

(ii) the aggregate amount allowed to the creditor—

(I) as deductions under subsection (a), (b), or (c) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange, shall be treated as an amount allowed as a deduction for depreciation.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) Taxpayers on reserve method.—In the case of a taxpayer to whom subsection (c) of section 166 (relating to reserve for bad debts) applies, the amount determined under clause (ii) of subparagraph (A) shall be the aggregate charges to the reserve resulting from the worthlessness or partial worthlessness of the indebtedness.

(C) Special rule for cash basis taxpayers.—In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(D) Stock of parent corporation.—For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(E) Treatment of successor corporation.—For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(F) Partnership rule.—Under regulations prescribed by the Secretary, rules similar to the rules of subparagraphs (A), (B), (C), (D), and (E) of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) Stock for debt exception not to apply in de minimis cases.—For purposes of determining income of the debtor for discharge of indebtedness, the stock for debt exception shall not apply—

(A) to the issuance of nominal or token shares, or

(B) with respect to an unsecured creditor, where the ratio of the value of the stock received by such unsecured creditor to the amount of his indebtedness cancelled or exchanged for stock in the workout is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout.

(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications.—Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

Page 16, line 13, strike out "Any interest" and insert "For purposes of this section, any interest".

Page 16, line 17, after "partnership," insert:

The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.

(D) Special rule in case of affiliated group.—For purposes of this section, if—

(i) a corporation holds stock in another corporation (hereinafter in this subparagraph referred to as the "subsidiary"), and

(ii) such corporations are members of the same affiliated group which file a consolidated return under section 1501 for the taxable year in which the discharge occurs, then such stock shall be treated as depreciable property to the extent that such subsidiary consents to a corresponding reduction in the basis of its depreciable property.

(E) Election to treat certain inventory as depreciable property.—

(i) In general.—At the election of the taxpayer, for purposes of this section, the term "depreciable property" includes any real property which is described in section 1221(1).

(ii) Election.—An election under clause (i) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary. Such an election, once made, may be revoked only with the consent of the Secretary.

Page 17, strike out lines 1 to 8, inclusive.

Page 17, line 9, strike out "(3)" and insert "(2)".

Page 17, strike out lines 14 to 19, inclusive and insert:

(1) In general.—For purposes of sections 1245 and 1250—

(A) any property the basis of which is reduced under this section and which is neither section 1245 property nor section 1250 property shall be treated as section 1245 property, and

Page 18, strike out all after line 10, over to and including line 7 on page 19, and insert:

(d) AMENDMENT OF SECTION 382(B).—Subsection (b) of section 382 (relating to special limitations on net operating loss carryover), as in effect before its amendment by section 806 of the Tax Reform Act of 1976, is amended by adding at the end thereof the following new paragraph:

(7) SPECIAL RULE FOR REORGANIZATIONS IN TITLE 11 OR SIMILAR CASES.—For purposes of this subsection, a creditor who receives stock in a reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) shall be treated as a stockholder immediately before the reorganization.

Page 20 in the matter following line 3, strike out "108(f)(1)(B)" and insert "108(e)(6)".

Page 20, strike out all of line 4 down to and including the matter which follows line 6.

Page 22, strike out lines 5 to 13, inclusive and insert:

(d) TAXABLE YEAR OF DEBTORS.—

(1) GENERAL RULE.—Except as provided in paragraph (2), the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.

Page 22, line 14, strike out "(3)" and insert "(2)".

Page 24, line 4, strike out "(4)" and insert "(3)".

Page 24, strike out all after line 8, down to and including the matter which follows line 9.

Page 24, line 16, after "Code." insert: "The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date (as defined in subsection (d)(3))".

Page 24, strike out all after line 21 over to and including line 3 on page 25.

Page 25, line 4, strike out "(4)" and insert "(3)".

Page 25, line 20, strike out "transfer" and insert "disposition".

Page 25, line 22, strike out "transfer" and insert "disposition".

Page 25, lines 23 and 24, strike out "transfer" and insert, "disposition".

Page 26, line 2, strike out "transfer" and insert "disposition".

Page 26, line 5, strike out "transfer" and insert "disposition".

Page 26, lines 6 and 7, strike out "transfer" and insert "disposition".

Page 45, strike out all after line 3, over to and including line 8 on page 46, and insert:

(g) TITLE 11 OR SIMILAR CASES.—If a corporation completely liquidates pursuant to a plan of complete liquidation adopted in a title 11 or similar case (within the meaning of section 368(a)(3)(A))—

(1) for purposes of subsection (a), the term 'property' shall not include any item acquired on or after the date of the adoption of the plan of liquidation if such item is not property within the meaning of subsection (b)(2), and

(2) subsection (a) shall apply to sales and exchanges by the corporation of property within the period beginning on the date of the adoption of the plan and ending on the date of the termination of the case".

Page 47, line 20, strike out "is" and insert "are".

Page 48, strike out lines 1 to 7, inclusive, and insert:

(f) EFFECT ON EARNINGS AND PROFITS.—Section 312 (relating to effect on earnings and profits) is amended by adding at the end thereof the following new subsection:

(1) DISCHARGE OF INDEBTEDNESS INCOME.—

(1) Does not increase earnings and profits if applied to reduce basis. The earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017.

(2) REDUCTION OF DEFICIT IN EARNINGS AND PROFITS IN CERTAIN CASES. If—

(A) the interest of any shareholder of a corporation is terminated or extinguished in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), and

(B) there is a deficit in the earnings and profits of the corporation, then such deficit shall be reduced by an amount equal to the paid-in capital which is allocable to the interest of the shareholder which is so terminated or extinguished.

Page 48, strike out all after line 22 over to and including line 3 on page 49, and insert:

(b) COORDINATION OF DEFICIENCY PROCEDURES WITH TITLE 11 CASES.—

(1) IN GENERAL.—Section 6213 (relating to restrictions applicable to deficiencies; petition to Tax Court) is amended by redesignating subsections (f) and (g) as subsections (g) and (h), respectively, and by inserting after subsection (e) the following new subsection:

Page 49, after line 20, insert:

(2) CLERICAL AMENDMENT.—Subsection (d) of section 6404 (relating to abatements) is amended by striking out "section 6213(f)(2)(A)" and inserting in lieu thereof "section 6213(g)(2)(A)".

Page 60, strike out all after line 5, over to and including line 14 on page 63, and insert:

SEC. 7 EFFECTIVE DATES.

(a) FOR SECTION 2 (RELATING TO TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS).—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by section 2 shall apply to any transaction which occurs after December 31, 1980, other than a transaction which occurs in a proceeding in a bankruptcy case or similar judicial proceeding (or in proceeding under the Bankruptcy Act) commencing on or before December 31, 1980.

(2) TRANSITIONAL RULE.—In the case of any discharge of indebtedness to which subparagraph (A) or (B) of section 108(a)(1) of the Internal Revenue Code of 1954 (relating to exclusion from gross income), as amended by section 2, applies and which occurs before January 1, 1982, or which occurs in a proceeding in a bankruptcy case or similar judicial proceedings commencing before January 1, 1982, then—

(A) section 108(b)(2) of such Code (relating to reduction of tax attributes), as so amended, shall be applied without regard to subparagraphs (A), (B), (C), and (E) thereof, and

(B) the basis of any property shall not be reduced under section 1017 of such Code (relating to reduction is basis in connection with discharges of indebtedness) as so amended, below the fair market value of such property on the date the debt is discharged.

(b) FOR SECTION 3 (RELATING TO RULES RELATING TO TITLE 11 CASES FOR INDIVIDUALS).—The amendments made by section 3 shall apply to any bankruptcy case commencing more than 90 days after the date of the enactment of this Act.

(c) FOR SECTION 4 (RELATING TO CORPORATE REORGANIZATION PROVISIONS).—

(1) IN GENERAL.—The amendments made by section 4 shall apply to any bankruptcy case or similar judicial proceeding commencing after December 31, 1980.

(2) EXCHANGES OF PROPERTY FOR ACCRUED INTEREST.—The amendments made by subsection (e) of section 4 (relating to treatment of property attributable to accrued interest) shall also apply to any exchange—

(A) which occurs after December 31, 1980, and

(B) which does not occur in a bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commenced on or before December 31, 1980.

(d) FOR SECTION 5 (RELATING TO MISCELLANEOUS CORPORATE AMENDMENTS).—

(1) FOR SUBSECTION (A) (RELATING TO EXEMPTION FOR PERSONAL HOLDING COMPANY TAX).—The amendments made by subsection (a) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(2) FOR SUBSECTION (B) (RELATING TO REPEAL OF SPECIAL TREATMENT FOR CERTAIN RAILROAD REDEMPTIONS).—The amendments made by subsection (b) of section 5 shall apply to stock which is issued after December 31, 1980 (other than stock issued pursuant to a plan of reorganization approved on or before that date).

(3) FOR SUBSECTION (C) (RELATING TO APPLICATION OF 12-MONTH LIQUIDATION RULE).—The amendment made by subsection (c) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(4) FOR SUBSECTION (D) (RELATING TO PERMITTING BANKRUPTCY ESTATE TO BE SUBCHAPTER S SHAREHOLDER).—The amendment made by subsection (d) of section 5 shall apply to any bankruptcy case commenced on or after October 1, 1979.

(5) FOR SUBSECTION (E) (RELATING TO CERTAIN TRANSFERS TO CONTROLLED CORPORATIONS).—The amendments made by subsection (e) of section 5 shall apply as provided in subsection (a) of this section.

(6) FOR SUBSECTION (F) (RELATING TO EFFECT OF DEBT DISCHARGE ON EARNINGS AND PROFITS).—The amendment made by subsection (f) of section 5 shall apply as provided in subsection (a) of this section.

(e) FOR SECTION 6 (RELATING TO CHANGES IN TAX PROCEDURES).—The amendments made by section 6 shall take effect on October 1, 1979, but shall not apply to any proceeding under the Bankruptcy Act commenced before October 1, 1979.

(f) ELECTION TO SUBSTITUTE SEPTEMBER 30, 1979, FOR DECEMBER 31, 1980.—
   (1) IN GENERAL.—The debtor (or debtors) in a bankruptcy case or similar judicial proceeding may (with the approval of the court) elect to apply subsections (a), (c), and (d) by substituting "September 30, 1979" for "December 31, 1980" each place it appears in such subsections.
   (2) EFFECT OF ELECTION.—Any election made under paragraph (1) with respect to any proceeding shall apply to all parties to the proceeding.
   (3) REVOCATION ONLY WITH CONSENT.—Any election under this subsection may be revoked only with the consent of the Secretary of the Treasury or his delegate.
   (4) TIME AND MANNER OF ELECTION.—Any election under this subsection shall be made at such time, and in such manner, as the Secretary of the Treasury or his delegate may by regulations prescribe.

(g) DEFINITIONS.—For purposes of this section—
   (1) BANKRUPTCY CASE.—The term "bankruptcy case" means any case under title 11 of the United States Code (as recodified by Public Law 95-598).
   (2) SIMILAR JUDICIAL PROCEEDING.—The term "similar judicial proceeding" means a receivership, foreclosure, or similar proceeding in a Federal or State court (as modified by section 368(a)(3)(D) of the Internal Revenue Code of 1954).

Mr. ROSTENKOWSKI (during the reading). Mr. Speaker, I ask unanimous consent that the Senate amendments be considered as read and printed in the Record.

The SPEAKER. Is there objection to the request of the gentleman from Illinois?

There was no objection.

The SPEAKER. Is there objection to the initial request of the gentleman from Illinois?

Mr. JACOBS. Mr. Speaker, I object.

The SPEAKER. Objection is heard.

BANKRUPTCY TAX ACT OF 1980

Mr. ULLMAN. Mr. Speaker, I ask unanimous consent to take from the Speaker's table the bill (H.R. 5043) to amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes, with Senate amendments thereto, and concur in the Senate amendments.

The Clerk read the title of the bill.

The Clerk read the Senate amendments, as follows:

Page 4, after the matter below line 20, insert:

   (E) FOREIGN TAX CREDIT CARRYOVERS.—Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 33.

Page 8, line 20, strike out "(5)" and insert "(6)".

Page 8, line 24, strike out "(6)" and insert "(7)".

Page 9, line 8, strike out "(7)" and insert "(8)".

Page 9, line 22, strike out "(8)" and insert "(9)".

Page 11, line 6, after "debtor." insert: "Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.".

Page 11, line 17, strike out "section 414(c)" and insert "subsection (b) or (c) of section 414".

Page 12, strike out all after line 9, over to and including line 9 on page 14, and insert:

   (6) INDEBTEDNESS CONTRIBUTED TO CAPITAL.—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.
   (7) RECAPTURE OF GAIN ON SUBSEQUENT SALE OF STOCK.—
      (A) In general.—If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245—
         (i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property, and

(ii) the aggregate amount allowed to the creditor—
(I) as deductions under subsection (a), (b), or (c) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or
(II) as an ordinary loss on the exchange, shall be treated as an amount allowed as a deduction for depreciation.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) TAXPAYERS ON RESERVE METHOD.—In the case of a taxpayer to whom subsection (c) of section 166 (relating to reserve for bad debts) applies, the amount determined under clause (ii) of subparagraph (A) shall be the aggregate charges to the reserve resulting from the worthlessness or partial worthlessness of the indebtedness.

(C) SPECIAL RULE FOR CASH BASIS TAXPAYERS.—In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(D) STOCK OF PARENT CORPORATION.—For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(E) TREATMENT OF SUCCESSOR CORPORATION.—For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(F) PARTNERSHIP RULE.—Under regulations prescribed by the Secretary, rules similar to the rules of subparagraphs (A), (B), (C), (D), and (E) of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) STOCK FOR DEBT EXCEPTION NOT TO APPLY IN DE MINIMIS CASES.—For purposes of determining income of the debtor for discharge of indebtedness, the stock for debt exception shall not apply—
(A) to the issuance of nominal or token shares, or
(B) with respect to an unsecured creditor, where the ratio of the value of the stock received by such unsecured creditor to the amount of his indebtedness cancelled or exchanged for stock in the workout is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout.

(9) DISCHARGE OF INDEBTEDNESS INCOME NOT TAKEN INTO ACCOUNT IN DETERMINING WHETHER ENTITY MEETS REIT QUALIFICATIONS.—Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

Page 16, line 13, strike out "Any interest" and insert "For purposes of this section, any interest".

Page 16, line 17, after "partnership", insert:

The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.

(D) SPECIAL RULE IN CASE OF AFFILIATED GROUP.—For purposes of this section, if—
(i) a corporation holds stock in another corporation (hereinafter in this subparagraph referred to as the "subsidiary"), and
(ii) such corporations are members of the same affiliated group which file a consolidated return under section 1501 for the taxable year in which the discharge occurs, then such stock shall be treated as depreciable property to the extent that such subsidiary consents to a corresponding reduction in the basis of its depreciable property.

(E) ELECTION TO TREAT CERTAIN INVENTORY AS DEPRECIABLE PROPERTY.—
(i) IN GENERAL.—At the election of the taxpayer, for purposes of this section, the term "depreciable property" includes any real property which is described in section 1221(1).
(ii) ELECTION.—An election under clause (i) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary. Such an election, once made, may be revoked only with the consent of the Secretary.

Page 17, strike out lines 1 to 8, inclusive.

Page 17, line 9, strike out "(3)" and insert "(2)".

Page 17, strike out lines 14 to 19, inclusive and insert:

(1) IN GENERAL.—For purposes of sections 1245 and 1250—

(A) any property the basis of which is reduced under this section and which is neither section 1245 property nor section 1250 property shall be treated as section 1245 property, and

Page 18, strike out all after line 10, over to and including line 7 on page 19, and insert:

(d) AMENDMENT OF SECTION 382(B).—Subsection (b) of section 382 (relating to special limitations on net operating loss carryover), as in effect before its amendment by section 806 of the Tax Reform Act of 1976, is amended by adding at the end thereof the following new paragraph:

(7) SPECIAL RULE FOR REORGANIZATIONS IN TITLE 11 OR SIMILAR CASES.—For purposes of this subsection, a creditor who receives stock in a reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) shall be treated as a stockholder immediately before the reorganization.

Page 20, in the matter following line 3, strike out "108(f)(1)(B)" and insert "108(e)(6)".

Page 20, strike out all of line 4 down to and including the matter which follows line 6.

Page 22, strike out lines 5 to 13, inclusive and insert:

(d) TAXABLE YEAR OF DEBTORS.—

(1) GENERAL RULE.—Except as provided in paragraph (2), the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.

Page 22, line 14, strike out "(3)" and insert "(2)".

Page 24, line 4, strike out "(4)" and insert "(3)".

Page 24, strike out all after line 8, down to and including the matter which follows line 9.

Page 24, line 16, after "Code," insert "The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date (as defined in subsection (d)(3)).".

Page 24, strike out all after line 21 over to and including line 3 on page 25.

Page 25, line 4, strike out "(4)" and insert "(3)".

Page 25, line 20, strike out "transfer" and insert "disposition".

Page 25, line 22, strike out "transfer" and insert "disposition".

Page 25, lines 23 and 24, strike out "transfer" and insert "disposition".

Page 26, line 2, strike out "transfer" and insert "disposition".

Page 26, line 5, strike out "transfer" and insert "disposition".

Page 26, lines 6 and 7, strike out "transfer" and insert "disposition".

Page 45, strike out all after line 3, over to and including line 8 on page 46, and insert:

(g) TITLE 11 OR SIMILAR CASES.—If a corporation completely liquidates pursuant to a plan of complete liquidation adopted in a title 11 or similar case (within the meaning of section 368(a)(3)(A)):

(1) for purposes of subsection (a), the term 'property' shall not include any item acquired on or after the date of the adoption of the plan of liquidation if such item is not properly within the meaning of subsection (b)(2), and

(2) subsection (a) shall apply to sales and exchanges by the corporation of property within the period beginning on the date of the adoption of the plan and ending on the date of the termination of the case".

Page 47, line 20, strike out "is" and insert "are".

Page 48, strike out lines 1 to 7, inclusive and insert:

(f) EFFECT ON EARNINGS AND PROFITS.—Section 312 (relating to effect on earnings and profits) is amending by adding at the end thereof the following new subsection:

(1) DISCHARGE OF INDEBTEDNESS INCOME.—

(A) Does not increase earnings and profits if applied to reduce basis. The earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017.

(2) REDUCTION OF DEFICIT IN EARNINGS AND PROFITS IN CERTAIN CASES.—If—

(A) the interest of any shareholder of a corporation is terminated or extinguished in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), and

(B) there is a deficit in the earnings and profits of the corporation, then such deficit shall be reduced by an amount equal to the paid-in capital which is allocable to the interest of the shareholder which is so terminated or extinguished.

Page 48, strike out all after line 22 over to and including line 3 on page 49, and insert:

(b) Coordination of Deficiency Procedures With Title 11 Cases.—

(1) In general.—Section 6213 (relating to restrictions applicable to deficiencies; petition to Tax Court) is amended by redesignating subsection (f) and (g) as subsections (g) and (h), respectively, and by inserting after subsection (e) the following new subsection:

Page 49, after line 20, insert:

(2) Clerical amendments.—Subsection (d) of section 6404 (relating to abatements) is amended by striking out "section 6213(f)(2)(A)" and inserting in lieu thereof "section 6213(g)(2)(A)."

Page 60, strike out all after line 5, over to and including line 14 on page 63, and insert:

SEC. 7 EFFECTIVE DATES.

(a) For Section 2 (Relating to Tax Treatment of Discharge of Indebtedness).—

(1) In general.—Except as provided in paragraph (2), the amendments made by section 2 shall apply to any transaction which occurs after December 31, 1980, other than a transaction which occurs in a proceeding in a bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commencing on or before December 31, 1980.

(2) Transitional rule.—In the case of any discharge of indebtedness to which subparagraph (A) or (B) of section 108(a)(1) of the Internal Revenue Code of 1954 (relating to exclusion from gross income), as amended by section 2, applies and which occurs before January 1, 1982, or which occurs in a proceeding in a bankruptcy case or similar judicial proceedings commencing before January 1, 1982, then—

(A) section 108(b)(2) of the such Code (relating to reduction of tax attributes), as so amended, shall be applied without regard to subparagraphs (A), (B), (C), and (E) thereof, and

(B) the basis of any property shall not be reduced under section 1017 of such Code (relating to reduction in basis in connection with discharges of indebtedness) as so amended, below the fair market value of such property on the date the debt is discharged.

(b) For Section 3 (Relating to Rules Relating to Title 11 Cases for Individuals).—The amendments made by section 3 shall apply to any bankruptcy case commencing more than 90 days after the date of the enactment of this Act.

(c) For Section 4 (Relating to Corporate Reorganization Provisions).—

(1) In general.—The amendments made by section 4 shall apply to any bankruptcy case or similar judicial proceeding commencing after December 31, 1980.

(2) Exchanges of property for accrued interest.—The amendments made by subsection (e) of section 4 (relating to treatment of property attributable to accrued interest) shall also apply to any exchange—

(A) which occurs after December 31, 1980, and

(B) which does not occur in a bankruptcy case or similar judicial proceeding (or in a proceeding under the Bankruptcy Act) commenced on or before December 31, 1980.

(d) For Section 5 (Relating to Miscellaneous Corporate Amendments).—

(1) For subsection (a) (relating to exemption for personal holding company tax).—The amendments made by subsection (a) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(2) For subsection (b) (relating to repeat of special treatment for certain railroad redemptions). The amendments made by subsection (b) of section 5 shall apply to stock which is issued after December 31, 1980 (other than stock issued pursuant to a plan of reorganization approved on or before that date).

(3) For subsection (c) (relating to application of 12-month liquidation rule).—The amendment made by subsection (c) of section 5 shall apply to any bankruptcy case or similar judicial proceeding commenced after December 31, 1980.

(4) For subsection (d) (relating to permitting bankruptcy estate to be subchapter s shareholder).—The amendment made by subsection (d) of section 5 shall apply to any bankruptcy case commenced on or after October 1, 1979.

(5) For subsection (e) (relating to certain transfers to controlled corporations).—The amendments made by subsection (e) of section 5 shall apply as provided in subsection (a) of this section.

(6) FOR SUBSECTION (F) (RELATING TO EFFECT OF DEBT DISCHARGE ON EARNINGS AND PROFITS).—The amendment made by subsection (f) of section 5 shall apply as provided in subsection (a) of this section.

(e) FOR SECTION 6 (RELATING TO CHANGES IN TAX PROCEDURES).—The amendments made by section 6 shall take effect on October 1, 1979, but shall not apply to any proceeding under the Bankruptcy Act commenced before October 1, 1979.

(f) ELECTION TO SUBSTITUTE SEPTEMBER 30, 1979, FOR DECEMBER 31, 1980.—

(1) IN GENERAL.—The debtor (or debtors) in a bankruptcy case or similar judicial proceeding may (with the approval of the court) elect to apply subsections (a), (c), and (d) by substituting "September 30, 1979" for "December 31, 1980" each place it appears in such subsections.

(2) Effect of election.-Any election made under paragraph (1) with respect to any proceeding shall apply to all parties to the proceeding.

(3) REVOCATION ONLY WITH CONSENT.—Any election under this subsection may be revoked only with the consent of the Secretary of the Treasury or his delegate.

(4) TIME AND MANNER OF ELECTION.—Any election under this subsection shall be made at such time, and in such manner, as the Secretary of the Treasury or his delegate may be regulations prescribe.

(g) DEFINITIONS.—For purposes of this section—

(1) BANKRUPTCY CASE.—The term "bankruptcy case" means any case under title 11 of the United States Code (as recodified by Public Law 95-598).

(2) SIMILAR JUDICIAL PROCEEDING.—The term "similar judicial proceeding" means a receivership, foreclosure, or similar proceeding in a Federal or State court (as modified by section 368(a)(3)(D) of the Internal Revenue Code of 1954).

Mr. ULLMAN (during the reading). Mr. Speaker, I ask unanimous consent that further reading of the Senate amendments be dispensed with and that they be printed in the Record.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Oregon?

Mr. CONABLE. Mr. Speaker, I reserve the right to object.

Mr. Speaker, I would ask the distinguished committee chairman if he would quickly summarize the two major amendments made by the Senate.

□ **1620**

Mr. ULLMAN. Mr. Speaker, will the gentleman yield?

Mr. CONABLE. I yield to the gentleman from Oregon.

Mr. ULLMAN. Mr. Speaker, I urge the House to concur in the Senate amendments to H.R. 5043, the Bankruptcy Tax Act of 1980, thereby completing action on this important bill which has been carefully developed over the past 2 years. Unless H.R. 5043 is enacted this year, there will be no statutory rules governing the tax treatment of debt discharge in bankruptcy and insolvency, and there will be confusion and controversy as to this issue and many other tax aspects of bankruptcy and discharge of indebtedness.

The Senate amendments, in brief summary, change the "stock-for-debt" rule and certain effective date provisions of the bill as passed by the House last March. First, the bill as amended generally returns to the present law rule developed by the courts that no income is recognized and no attribute reduction is required if a corporation issues its stock to creditors in cancellation of outstanding debt. By providing for favorable tax treatment if stock is issued to creditors in discharge of debt, this amendment seeks to encourage reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.

Second, under the Senate amendments the provisions of the bill relating to debt discharge in bankruptcy, tax-free bankruptcy reorganizations, and certain miscellaneous corporate amendments generally will apply to bankruptcy cases beginning after December 31, 1980. In the case of a bankrupt or insolvent debtor, however, the rule that the debtor must reduce net operating losses by the amount of debt discharge—or alternatively, must reduce basis in depreciable assets—will not apply to debt discharge which occurs in a bankruptcy case beginning before January 1, 1982.

Mr. Speaker, I believe that, in light of the pressing need for enacting bankruptcy tax legislation this year, these modifications represent an acceptable approach in seeking to strike a fair balance between tax policy and bankruptcy concerns.

Both the House Ways and Means Committee and the Senate Finance Committee have recognized that the development of tax rules for bankruptcy and insolvency can involve accommodation of tax policy and bankruptcy concerns—that is, the most appropriate tax rules may reflect neither pure tax theory on the one hand nor complete subordination of tax principles to asserted bankruptcy concerns on the other hand. The tax committees, in seeking to strike a fair balance between sometimes conflicting policies, have carefully considered the extensive testimony—at three hearings on bankruptcy tax legislation—and many additional written comments submitted by bar association groups, accounting groups, bankruptcy attorneys, and other groups and individuals with experience in bankruptcy tax matters, plus the views of the Treasury and Justice Departments and the Internal Revenue Service.

With respect to the issue of tax treatment of debt discharge, both the Ways and Means Committee and the Finance Committee agree that the basic-reduction mechanisms under the-now repealed—Bankruptcy Act and under present Internal Revenue Code sections 108 and 1017 fail to effectuate the congressional intent of deferring, but eventually collecting tax on, ordinary income from debt discharge. The rules of the bill requiring a bankrupt or insolvent debtor to apply the debt discharge amount to reduce net operating losses—or basis in depreciable assets—are intended to carry out this congressional intent, while giving the debtor the flexibility of reducing either net operating losses or basis in depreciable assets. This basic approach-requiring reduction of net operating losses by the debt discharge amount before reduction in basis of nondepreciable assets—was recommended by the 1973 report of the Commission on the Bankruptcy Laws—established by Congress, endorsed during the 95th Congress by the House Judiciary Committee, enacted for State and local tax purposes in Public Law 95-598, and supported during consideration of H.R. 5043 by the American Bar Association Tax Section, the New York City Bar Tax Committee, and other groups and individuals as well as the Treasury.

Thus both tax committees are in accord on this fundamental point, as reflected in the two committee reports on H.R. 5043. However, because considerable time has elapsed since introduction of the House bill, and particularly in light of the overwhelming consideration of the need for legislation this year, the postponement of certain effective dates made by the Senate amendments is acceptable. The concurrence by the House in this effective date postponement should not be interpreted as suggesting that the Ways and Means Committee sees any need for reconsideration of the attribute-reduction rules of the bill.

The following is a more detailed description of the amendments made by the Senate to H.R. 5043 as passed by the House.

"STOCK-FOR-DEBT" RULES

The Senate amendments modify certain rules in the House bill with respect to the income tax treatment of discharge of indebtedness.

The House bill provided that if a corporation issues stock in cancellation of short-term debt or trade credit, the corporate debtor would be required to reduce tax attributes by an amount equal to the excess of the indebtedness over the value of the stock. The Senate amendment generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt—whether or not the debt constitutes a security for tax purposes. Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt. This stock-for-debt rule under the amendment will not apply if only a de minimis amount of stock is issued for the outstanding debt.

The amendment also changes rules of the House bill with respect to issuance of a package of stock and other property in cancellation of debt. Under the House bill, the stock would be treated as issued for a proportion of the debt equal to its proportion of the value of the total consideration. Under the amendment, the cash or other property would be treated as satisfying an equal amount of debt, and the stock as satisfying the remainder of the debt. Consequently, there would be no tax consequences to the debtor—subject to the de minimis exception stated above.

The amendment also provides that if a creditor receiving stock for debt has taken an ordinary bad debt deduction, any gain on a later sale of the stock by the creditor would be "recaptured" as ordinary income up to the amount of the creditor's prior deduction against income.

Under the Senate amendment, the provision of the House bill excepting stock for debt exchanges in a bankruptcy or similar case from code section 382(a) would be deleted.

effective date provisions

The Senate also amended certain effective date provisions of the House bill.

Under the House bill, the provisions relating to tax treatment of debt discharge (section 2), corporate reorganizations in bankruptcy (section 4), and certain miscellaneous corporate amendments (section 5) would apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979.

Under the amendment, the provisions of sections 2, 4, and 5 of the bill generally would apply to bankruptcy cases (or receivership, etc. proceedings) commenced after December 31, 1980. However, some taxpayers may have entered into bankruptcy reorganizations with the expectation that the bill would be enacted with the original retroactive effective dates. Accordingly, the amendment allows a bankrupt or insolvent debtor to elect to have all the debt discharge and related provisions of the bill apply retroactively (in the case of proceedings commenced on or after October 1, 1979).

The amendment also postpones for 1 additional year the requirement under the bill that a bankrupt or insolvent debtor must reduce net operating losses by the amount of debt discharge (or alternatively, must reduce basis in depreciable assets). Under the Senate amendment, this attribute reduction requirement will not apply, in the case of a bankrupt or insolvent debtor, to debt discharge which occurs before January 1, 1982 or which occurs in a bankruptcy case or similar judicial proceeding beginning before January 1, 1982.

Thus, under the amendment, a bankrupt or insolvent debtor will apply the amount of debt discharge to reduce basis in assets in the case of a debt discharge to which the bill applies occurring before January 1, 1982 or occurring in a bankruptcy case or similar proceeding commencing before January 1, 1982. Furthermore, such a debtor will not be required to reduce asset basis below fair market value. Under the amendment, any amount of debt discharge remaining after asset basis is so reduced will not have any tax consequences—that is, the remaining amount will not be included in income and will not result in reduction of net operating losses or other tax attributes. Thus, in the case of debt discharge before 1982, or bankruptcy cases or similar judicial proceedings beginning before 1982, bankrupt or insolvent debtors will be subject to a basis reduction rule like that in the now repealed provisions of the Bankruptcy Act.

In the case of solvent debtors outside bankruptcy—or receiverships, et cetera, the rules of the bill generally would apply to transactions after December 31, 1980, and the Senate amendment does not change this provision.

TECHNICAL AMENDMENTS

The Senate also adopted the following technical and clarifying amendments to the House bill.

SECTION 2.—TAX TREATMENT OF DISCHARGE OF INDEBTEDNESS

First. Election to reduce basis in depreciable assets held by certain subsidiaries—modification to section 2(b) of the bill, amending Code section 1017.

Under the House-passed bill, a debtor in bankruptcy or an insolvent debtor could elect to apply the amount of discharged debt first to reduce basis in depreciable property, before applying any remaining amount to reduction of specified tax attributes. Similarly, a solvent debtor outside bankruptcy could elect to reduce basis in depreciable assets instead of recognizing current income from debt cancellation. To insure that ordinary income treatment eventually would be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" as ordinary income.

The amendment would expand these election provisions to provide also that if the debtor is a parent holding company which files a consolidated tax return with a subsidiary, the debtor could elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of the stock of the subsidiary to the extent the subsidiary consents to reduce the basis of its depreciable assets. The "recapture" rule stated above would apply to a disposition of the reduced-basis assets.

Second. Election to reduce basis in realty held as inventory—modification to section 2(b) of the bill, amending code section 1017.

The election provisions summarized in paragraph 1 above would be further expanded by the amendment to also allow application of the debt discharge amount to reduce basis in real property held primarily for sale to customers in the ordinary course of a trade or business-within the meaning of code section 1221(1). To the extent the debtor elects to reduce basis in such realty, the particular real properties the bases of which would be reduced are to be determined pursuant to Treasury regulations. A subsequent disposition of reduced-basis realty would result in recognition of a larger

amount of ordinary income, just as reduction in basis of depreciable assets results in lower depreciation deductions to offset ordinary income.

Third. Discharge of partnership debt, modification to section 2(b) of the bill.

The House-passed bill provides that if a taxpayer must account for a debt discharge amount because indebtedness is canceled, the taxpayer's interest in any partnership may be treated as depreciable property to the extent of his interest in depreciable property of the partnership. Under the bill, in the case of discharge of partnership debt, the partner could elect to reduce the basis of his partnership interest—in lieu of attribute reduction or income recognition—only if the partnership makes a corresponding reduction in the basis of depreciable assets of the partnership with respect to such partner.

The amendment would clarify that a partner's interest in any partnership (whether or not that partnership's debt was discharged) may be treated as a depreciable asset only if the partnership makes a corresponding reduction in the basis of depreciable assets of the partnership with respect to such partner. Also, the amendment would state that the amount of reduction in the partner's basis in the partnership interest, and the particular depreciable assets of the partnership the bases of which are to be reduced, are to be determined pursuant to Treasury regulations.

Fourth. Debt acquired by related parties, modification to section 2(a) of the bill, amending Code section 108.

The House-passed bill provides that, for purposes of the debt discharge rules, acquisition of a debt by a related party would be treated as acquisition by the debtor. The Ways and Means Committee report states that the income tax consequences of repayment or capital contribution of a debt which had been acquired by a related party are to be provided in Treasury regulations. The report further indicates that the tax consequences would include allowing the debtor a deduction equal to the amount of any gain or income recognized by the related party if the debt is repaid or contributed to capital (House Rep. 96-833, p. 16).

The related party rules in the bill would be amended to add a provision stating that the tax treatment of a repayment or a capital contribution of a debt which had been acquired by a related party would, pursuant to Treasury regulations, be substantially the same as if the debtor itself 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 subsidiary has a debt discharge amount of $100. If the subsidiary pays its parent the full principal amount ($1,000) when the debt matures, the Treasury regulations would treat the $100 difference as a dividend to the parent, against which the dividends received deduction would be available as provided by present law (Code section 243-246). The repayment would not have any tax consequences to the subsidiary. Likewise, if the debt were later cancelled, the parent would be treated as having contributed $900 to the subsidiary (with no tax consequences).

Fifth. Reduction of certain credit carryovers on debt discharge in bankruptcy or insolvency modification to section 2(a) of the bill, amending Code section 108.

Unless the taxpayer elects first to reduce basis in depreciable assets or in section 1221(1) realty, the amount of debt discharge in bankruptcy—or in the case of an insolvent debtor—would be applied under the House-passed bill to reduce net operating losses or carryovers, carryovers of certain tax credits, capital losses and carryovers, and the basis of the taxpayer's assets. These provisions would be modified also to provide that if any debt discharge amount remains after reduction of such attributes—including any debt discharge amount which remains unapplied solely by virtue of the limitation in the bill with respect to basis reduction, such remaining amount would be applied to reduce carryovers of the foreign tax credit.

Sixth. Real estate investment trusts, modification to section 2 of the bill.

To qualify as a real estate investment trust (REIT), an organization must satisfy, among other requirements, source-of-income tests establishing that it has primarily passive income from real estate investments (Code section 856). In light of the bill's rules governing the tax consequences of debt discharge, the amendment would add a provision specifying that income from cancellation of indebtedness is not to be taken into account for the source-of-income tests. For example, if a solvent REIT investing primarily in mortgages has debt cancellation on redemption of bonds, and such amount would be includable in gross income under the rules of the bill—absent an election to apply such amount to reduce the basis of depreciable assets, the amount of such income would not be taken into account for purposes of Code section 856.

Seventh. Amendment to Code section 382(b), modification of section 2(d) of the bill, amending Code section 382.

The House-passed bill provides that creditors of a debtor corporation would be treated as shareholders in applying the continuity rules of Code section 382(b) to a "G" reorganization. The amendment would extend this rule to apply to any reorganization in a bankruptcy or similar case, rather than solely in a "G" reorganization.

SECTION 3.—RULES RELATING TO TITLE 11 CASES FOR INDIVIDUALS

First. Taxable year of the estate—prop. code section 1398(d)(1).

The House-passed bill provides that the first taxable year of the bankruptcy estate of an individual debtor ends on the same day as the debtor's taxable year which includes the date on which the bankruptcy case commences. This rule had been developed as a part of a prior version of the bill, which would have required that the estate report certain income recognized prior to commencement of the case. Inasmuch as the bill has been changed and now permits the debtor to close his or her taxable year on commencement of the case, the rule relating to the estate's taxable year no longer is necessary and accordingly would be deleted by the amendment.

Second. Estate's share of the debtor's income—prop. code section 1398(e)(1).

The House-passed bill provides that the gross income of the bankruptcy estate of an individual debtor would include any gross income of the debtor to which the estate is entitled under bankruptcy law. The amendment would clarify that only such income which is recognized after commencement of the case would be includable in the estate's gross income.

Third. Allocation of deductions and credits—prop. code section 1398(e)(3).

In cases where the bankruptcy estate of an individual would be treated as a separate taxable entity, the House-passed bill provides rules for allocating deduction and credits between the debtor and the estate. The amendment would modify these rules to make clear that only those expenses paid or accrued by the debtor which are not properly allowable to the debtor would be allocated to the estate. For example, an expense paid by a cash basis debtor before commencement of the bankruptcy case would be allowed to the debtor, even if such deduction could be considered to be associated with income which is allocated to the estate under the rules of the bill. Also, an expense paid or accrued by the debtor after commencement of the bankruptcy case would be allocated to the debtor, and not to the estate.

Fourth. No disposition rules—prop. code section 1398(f).

The bill provides that a transfer (other than by sale or exchange) of an asset from an individual debtor to the bankruptcy estate, or from the bankruptcy estate to the debtor on termination of the estate, would not be treated as a "transfer" giving rise to recognition of gain or loss, recapture of deductions, or acceleration of income or deductions. To conform with language used in related Code provisions, these provisions would be modified to provide that such a transfer would not be treated as a "disposition" for tax purposes.

Fifth. Carryover of attributes to debtors—prop. code section 1398(i).

The bill provides that on termination of a bankruptcy estate, the debtor would succeed to various tax attributes of the estate. This provision would be modified to make clear that the carryover includes attributes first arising during administration of the estate (other than the new administrative expense deduction which would be provided under the bill).

SECTION 5.—MISCELLANEOUS CORPORATE AMENDMENTS

First. Application of section 337 liquidation rule to insolvent corporations—modification to section 5(c) of the bill, amending code section 337.

The House bill expands the nonrecognition provisions under code section 337 to allow a liquidating corporation in a bankruptcy or similar case generally to sell its assets tax-free during the entire duration of the proceeding. The amendment would make this provision applicable whether or not any shareholder receives any consideration for this stock and also would clarify that assets may be retained to pay administrative claims following the close of the case.

Second. Effect of discharge of indebtedness on earnings and profits—modification of section 5(f) of the bill, amending Code section 312.

The House bill provides that to the extent income from discharge of indebtedness—including an amount excluded from gross income pursuant to Code section 108, as amended by the bill—is applied to reduce basis under Code section 1017, such basis-reduction amount does not affect the debtor corporation's earnings and profits. Otherwise, discharge of indebtedness income, including amounts excluded from gross income—pursuant to Code section 108, as amended by the bill, increases the earnings and profits of the corporation (or reduces a deficit). The amendment would

provide also that any deficit in earnings and profits would be reduced by the capital account of any shareholder whose interest is eliminated in a bankruptcy proceeding.

Mr. CONABLE. Mr. Speaker, further reserving the right to object, the first amendment delays for 1 year the application of the bill's attribution reduction rules and adds the bankruptcy and insolvency section. Is that correct? And the second amendment liberalizes the debt provisions of the House bill.

Mr. ULLMAN. The gentleman is correct.

Mr. CONABLE. Mr. Speaker, I rise in support of H.R. 5043, the Bankruptcy Tax Act of 1980, as amended by the other body.

As the Members will recall, the House earlier this year unanimously passed H.R. 5043. The other body adopted the House-passed bill with only two major amendments.

The first amendment would delay for 1 year the application of the bill's attribution reduction rules in the case of bankrupt of insolvent taxpayers. The amendment does not delay the application of these rules in the case of solvent taxpayers.

The second amendment liberalizes the "stock for debt" provisions of the House bill. The amendment provides that the exchange of stock for short-term debt will not result in the reduction of attributes except where the amount of stock exchanged is de minimis. Under the House-passed bill, the exchange of stock for short-term debt resulted in attribute reduction; while the exchange of stock for long-term debt or a security, did not trigger this type of reduction.

The other amendments made by the other body are technical in nature.

The bill represents the efforts of several professional organizations and the Treasury Department. The Select Revenue Measures Subcommittee and particularly its chairman, Mr. Rostenkowski, are to be complimented for their efforts in putting this bill together and reconciling the various differences that existed.

I urge the bill's passage.

• Mr. DUNCAN of Tennessee. Mr. Speaker, I support the chairman's unanimous consent request to accept H.R. 5043, the Bankruptcy Tax Act of 1980 as amended by the Senate.

The legislation is a necessary follow-on to the legislation earlier in this Congress which altered the substantive bankruptcy law. H.R. 5043 updates the tax treatment of bankruptcy to complement the new bankruptcy law.

The Senate made only two major amendments to H.R. 5043. First, it adopted an amendment which postpones for 1 year the effective date of certain rules in section 2 regarding the reduction of a net operating loss and basis of depreciable assets with respect to a bankrupt or insolvent debtor. My understanding is that this postponement is supported by elements of the bankruptcy bar. They apparently believe these provisions should be reviewed further. After the 1-year postponement ends, then these rules will become effective unless subsequent congressional action amends them.

The second amendment expands the stock for debt provisions. It provides that the exchange of stock for short-term debt will not result in the reduction of attributes in certain situations.

Mr. Speaker, H.R. 5043 passed the House on March 24, 1980, on a recorded vote with not one Member casting a nay vote. I believe the Senate amendments are acceptable and accordingly the bill before us now likewise merits our unanimous approval.

Mr. CONABLE. Mr. Speaker, I withdraw my reservation of objection.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Oregon?

There was no objection.

The SPEAKER pro tempore. Is there objection to the initial request of the gentleman from Oregon?

There was no objection.

A motion to reconsider was laid on the table.

GENERAL LEAVE

Mr. ULLMAN. Mr. Speaker, I ask unanimous consent that all Members may have 5 legislative days in which to revise and extend their remarks on the legislation first considered.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Oregon?

There was no objection.

APPENDIX E

Selected Provisions from the General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)

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DISCHARGE OF INDEBTEDNESS INCOME FOR CERTAIN FARMERS (SEC. 405 OF THE ACT AND SECS. 108 AND 1017 OF THE CODE)[1]

Prior Law

Under prior and present law, gross income is defined to include income from discharge of indebtedness (sec. 61). If a solvent taxpayer received income from discharge of trade or business indebtedness, prior law provided the taxpayer an election to exclude that income if the taxpayer's basis in depreciable property was reduced (secs. 108 and 1017). If the amount of the discharge of indebtedness income exceeded a solvent taxpayer's available basis, the taxpayer recognized income in an amount of the excess.

Under prior (and present) law, if an insolvent taxpayer receives income from discharge of indebtedness, the income is excluded (to the extent it does not exceed the amount of the taxpayer's insolvency).[2] The taxpayer's tax attributes must be reduced by the amount of the excluded income. Reduction is required in the following attributes (in the following order): net operating losses and carryovers, general business credit carryovers, capital loss carryovers, basis of property,[3] and foreign

[1] For legislative background of the provision, *see*: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 706; S.Rep. 99-313, pp. 271–272; Senate floor amendment, 132 Cong. Rec. S7827 (June 18, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 115–116 (Conference Report).

[2] The amount of a taxpayer's insolvency is the excess of its liabilities over the fair market value of its assets.

[3] The reduction in basis is limited to the excess of the aggregate bases of the taxpayer's property over the taxpayer's aggregate liabilities immediately after the discharge.

tax credit carryovers. An insolvent taxpayer may elect to reduce basis in depreciable property before reducing net operating losses or other attributes.

If the amount of the insolvent taxpayer's discharge of indebtedness income (not in excess of the amount of its insolvency) exceeds its available tax attributes, the excess is disregarded, i.e., is not includible in income.

Reasons for Change

Congress was aware of enacted and pending legislation intended to alleviate the credit crisis in the farming sector, and of potential tax problems that might undermine the effectiveness of this legislation. For example, programs providing Federal guarantees on limited amounts of farm indebtedness in exchange for a lender's agreement to reduce the total amount of a farmer's indebtedness when that farmer had a high debt-to-equity ratio (but was not insolvent) were under consideration. Congress was concerned that such farmers would recognize large amounts of discharge of indebtedness income as a result of these loan write-downs—forcing them to forfeit their farmland rather than participate in programs designed to enable them to continue in farming.

Explanation of Provision

Under the Act, certain solvent taxpayers realizing income from the discharge of certain farming-related indebtedness may reduce tax attributes, including basis in property, under rules similar to those applicable to insolvent taxpayers. The discharged indebtedness must have been incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a gross receipts test.[4] The gross receipts test is satisfied if the taxpayer's aggregate gross receipts from farming for the three years preceding the year of the discharge are 50 percent or more of his aggregate gross receipts from all sources for the same period.[5]

If a taxpayer elects to exclude income under this provision, the excluded amount must be applied to reduce tax attributes of the taxpayer in the following order: (1) net operating losses, (2) general business credits, (3) capital loss carryovers, (4) foreign tax credit carryovers, (5) basis in property other than land used or held for use in the trade or business of farming, and (6) basis in land used or held for use in the trade or business of farming.

The amount of the exclusion under this provision may not exceed the aggregate amount of the tax attributes of the taxpayer specified above. Accordingly, income must be recognized to the extent the amount of the discharged indebtedness exceeds his available attributes.[6]

Effective Date

The provision applies to discharge of indebtedness income realized after the April 9, 1986, in taxable years ending after that date.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by $9 million in 1987, $10 million in 1988, $8 million in 1989, $7 million in 1990, and $5 million in 1991.

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[4] As under prior law, discharges of nonrecourse "loans" made by the Commodity Credit Corporation in connection with governmental crop price support programs, or other similar transactions that in substance constitute a sale of a farm product, are not within the scope of section 108 and hence are ineligible for relief under this provision.

[5] A technical amendment may be necessary to clarify that this was the intended operation of the gross receipts test.

[6] A technical amendment may be necessary to conform the Congress' intent that the relief for solvent farmers be as described above.

SPECIAL LIMITATIONS ON NET OPERATING LOSS AND OTHER CARRYFORWARDS (SEC. 621 OF THE ACT AND SECS. 382 AND 383 OF THE CODE)[7]

Prior Law

Overview

In general, a corporate taxpayer is allowed to carry a net operating loss ("NOL(s)") forward for deduction in a future taxable year, as long as the corporation's legal identity is maintained. After certain nontaxable asset acquisitions in which the acquired corporation goes out of existence, the acquired corporation's NOL carryforwards are inherited by the acquiring corporation. Similar rules apply to tax attributes other than NOLs, such as net capital losses and unused tax credits. Historically, the use of NOL and other carryforwards has been subject to special limitations after specified transactions involving the corporation in which the carryforwards arose (referred to as the "loss corporation"). Prior law also provided other rules that were intended to limit tax-motivated acquisitions of loss corporations.

The operation of the special limitations on the use of carryforwards turned on whether the transaction that caused the limitations to apply took the form of a taxable sale or exchange of stock in the loss corporation or one of certain specified tax-free reorganizations in which the loss corporation's tax attributes carried over to a corporate successor. After a purchase (or other taxable acquisition) of a controlling stock interest in a loss corporation, NOL and other carryforwards were disallowed unless the loss corporation continued to conduct its historical trade or business. In the case of a tax-free reorganization, NOL and other carryforwards were generally allowed in full if the loss corporation's shareholders received stock representing at least 20 percent of the value of the acquiring corporation.

NOL and Other Carryforwards

Although the Federal income tax system generally requires an annual accounting, a corporate taxpayer was allowed to carry NOLs back to the three taxable years preceding the loss and then forward to each of the 15 taxable years following the loss year (sec. 172). The rationale for allowing the deduction of NOL carryforwards (and carrybacks) was that a taxpayer should be able to average income and losses over a period of years to reduce the disparity between the taxation of businesses that have stable income and businesses that experience fluctuations in income.[8]

In addition to NOLs, other tax attributes eligible to be carried back or forward include unused investment tax credits (secs. 30 and 39), excess foreign tax credits (sec. 904(c)), and net capital losses (sec. 1212). Like NOLs, unused investment tax credits were allowed a three-year carryback and a 15-year carryforward. Subject to an overall limitation based on a taxpayer's U.S. tax attributable to foreign-source income, excess foreign tax credits were allowed a two-year carryback and a five-year carryforward. For net capital losses, generally, corporations had a three-year carryback (but only to the extent the carrybacks did not increase or create a NOL) and a five-year carryforward.

NOL and other carryforwards that were not used before the end of a carryforward period expired.

Carryovers to Corporate Successors

In general, a corporation's tax history (e.g., carryforwards and asset basis) was preserved as long as the corporation's legal identity was continued. Thus, under the general rules of prior law, changes in the stock ownership of a corporation did not affect the corporation's tax attributes. Following are examples of transactions that effected ownership changes without altering the legal identity of a corporation:

(1) A taxable purchase of a corporation's stock from its shareholders (a "purchase"),

(2) A type "B" reorganization, in which stock representing control of the acquired corporation is acquired solely in exchange for voting stock of the acquiring corporation (or a corporation in control of the acquiring corporation) (sec. 368(a)(1)(B)),

[7] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 321; H. Rep. 99-426, pp. 250–273; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 621; Rep. 99-313, pp. 224–248; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 170–196 (Conference Report).

[8] H.R. Rep. No. 1337, 83d Cong., 2d sess. 27 (1954).

(3) A transfer of property to a corporation after which the transferors own 80 percent or more of the corporation's stock (a "section 351 exchange"),

(4) A contribution to the capital of a corporation, in exchange for the issuance of stock, and

(5) A type "E" reorganization, in which interests of investors (shareholders and bondholders) are restructured (sec. 368(a)(1)(E)).

Statutory rules also provided for the carryover of tax attributes (including NOL and other carryforwards) from one corporation to another in certain tax-free acquisitions in which the acquired corporation went out of existence (sec. 381). These rules applied if a corporation's assets were acquired by another corporation in one of the following transactions:

(1) The liquidation of an 80-percent owned subsidiary (sec. 332),

(2) A statutory merger or consolidation, or type "A" reorganization (sec. 368(a)(1)(A)),

(3) A type "C" reorganization, in which substantially all of the assets of one corporation is transferred to another corporation in exchange for voting stock, and the transferor completely liquidates (sec. 368(a)(1)(C)),

(4) A "nondivisive D reorganization," in which substantially all of a corporation's assets are transferred to a controlled corporation, and the transferor completely liquidates (secs. 368(a)(1)(D) and 354(b)(1)),

(5) A mere change in identity, form, or place of organization of a single corporation, or type "F" reorganization (sec. 368(a)(1)(F)), and

(6) A type "G" reorganization, in which substantially all of a corporation's assets are transferred to another corporation pursuant to a court approved insolvency or bankruptcy reorganization plan, and stock or securities of the transferee are distributed pursuant to the plan (sec. 368(a)(1)(G)).

In general, to qualify an acquisitive transaction (including a B reorganization) as a tax-free reorganization, the shareholders of the acquired corporation had to retain "continuity of interest." Thus, a principal part of the consideration used by the acquiring corporation had to consist of stock, and the holdings of all shareholders had to be traced. Further, a tax-free reorganization was required to satisfy a "continuity of business enterprise" test. Generally, continuity of business enterprise requires that a significant portion of an acquired corporation's assets be used in a business activity (see Treas. reg. sec. 1.368-1(d)).

Acquisitions to Evade or Avoid Income Tax

The Secretary of the Treasury was authorized to disallow deductions, credits, or other allowances following an acquisition of control of a corporation or a tax-free acquisition of a corporation's assets if the principal purpose of the acquisition was tax avoidance (sec. 269). This provision applied in the following cases:

(1) where any person or persons acquired (by purchase or in a tax-free transaction) at least 50 percent of a corporation's voting stock, or stock representing 50 percent of the value of the corporation's outstanding stock;

(2) where a corporation acquired property from a previously unrelated corporation and the acquiring corporation's basis for the property was determined by reference to the transferor's basis; and

(3) where a corporation purchased the stock of another corporation in a transaction that qualified for elective treatment as a direct asset purchase (sec. 338), a section 338 election was not made, and the acquired corporation was liquidated into the acquiring corporation (under sec. 332).

Treasury regulations under section 269 provided that the acquisition of assets with an aggregate basis that is materially greater than their value (i.e., assets with built-in losses), coupled with the utilization of the basis to create tax-reducing losses, is indicative of a tax-avoidance motive (Treas. reg. sec. 1.269-3(c)(1)).

Consolidated Return Regulations

To the extent that NOL carryforwards were not limited by the application of section 382 or section 269, after an acquisition, the use of such losses might be limited under the consolidated return regulations. In general, if an acquired corporation joined the acquiring corporation in the filing of a consolidated tax return by an affiliated group of corporations, the use of the acquired corporation's preacquisition NOL carryforwards against income generated by other members of the group was limited by the "separate return limitation year" ("SRLY") rules (Treas. reg. sec. 1.1502-21(c)). An acquired corporation was permitted to use pre-acquisition NOLs only up to the amount of its own contribution to the consolidated group's taxable income. Section 269 was available to prevent taxpayers from avoiding the SRLY rules by diverting income-producing activities (or contributing

income-producing assets) from elsewhere in the group to a newly acquired corporation (see Treas. reg. sec. 1.269-3(c)(2), to the effect that the transfer of income-producing assets by a parent corporation to a loss subsidiary filing a separate return may be deemed to have tax avoidance as a principal purpose).

Applicable Treasury regulations provided rules to prevent taxpayers from circumventing the SRLY rules by structuring a transaction as a "reverse acquisition" (defined in regulations as an acquisition where the "acquired" corporation's shareholders end up owning more than 50 percent of the value of the "acquiring" corporation) (Treas. reg. sec. 1.1502-75(d)(3)). Similarly, under the "consolidated return change of ownership" ("CRCO") rules, if more than 50 percent of the value of stock in the common parent of an affiliated group changed hands, tax attributes (such as NOL carryforwards) of the group were limited to use against post-acquisition income of the members of the group (Treas. reg. sec. 1.1502-21(d)).

Treasury regulations also prohibited the use of an acquired corporation's built-in losses to reduce the taxable income of other members of an affiliated group (Treas. reg. sec. 1.1502-15). Under the regulations, built-in losses were subject to the SRLY rules. In general, built-in losses were defined as deductions or losses that economically accrued prior to the acquisition but were recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(a)(2)). The built-in loss limitations did not apply unless, among other things, the aggregate basis of the acquired corporation's assets (other than cash, marketable securities, and goodwill) exceeded the value of those assets by more than 15 percent.

Allocation of Income and Deductions Among Related Taxpayers

The Secretary of the Treasury was authorized to apportion or allocate gross income, deductions, credits, or allowances, between or among related taxpayers (including corporations), if such action was necessary to prevent evasion of tax or to clearly reflect the income of a taxpayer (sec. 482). Section 482 could apply to prevent the diversion of income to a loss corporation in order to absorb NOL carryforwards.

Libson Shops Doctrine

In *Libson Shops v. Koehler*, 353 U.S. 382 (1957) (decided under the 1939 Code), the U.S. Supreme Court adopted a test of business continuity for use in determining the availability of NOL carryovers. The court denied NOL carryovers following the merger of 16 identically owned corporations (engaged in the same business at different locations) into one corporation, on the ground that the business generating post-merger income was not substantially the same business that incurred the loss (three corporations that generated the NOL carryovers continued to produce losses after the merger).

There was uncertainty whether the *Libson Shops* doctrine had continuing application as a separate nonstatutory test under the 1954 Code. *Compare Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965) (holding that *Libson Shops* is inapplicable to years governed by the 1954 Code) with Rev. Rul. 63-40, 1963-1 C.B.46, as modified by T.I.R. 773 (October 13, 1965) (indicating that *Libson Shops* may have continuing vitality where, inter alia, there is a shift in the "benefits" of an NOL carryover).[9]

1954 Code Special Limitations

The application of the special limitations on NOL carryforwards was triggered under the 1954 Code by specified changes in stock ownership of the loss corporation (sec. 382). In measuring changes in stock ownership, section 382(c) specifically excluded "nonvoting stock which is limited and preferred as to dividends." Different rules were provided for the application of special limitations on the use of carryovers after a purchase and after a tax-free reorganization. Section 382 did not address the treatment of built-in losses.

If the principal purpose of the acquisition of a loss corporation was tax avoidance, section 269 would apply to disallow NOL carryforwards even if section 382 was inapplicable. Similarly, the SRLY rules could apply even if section 382 did not apply.

[9] The legislative history of the 1976 Act amendments to section 382—discussed below—specifically provided that *Libson Shops* would have no application to years governed by those amendments. *See* S. Rep. 938, 94th Cong., 2d Sess. p. 206 (1976).

Taxable purchases

If the special limitations applied after a purchase, NOL carryforwards were disallowed entirely under the 1954 Code. The rule for purchases applied if (1) one or more of the loss corporation's ten largest shareholders increased their common stock ownership within a two-year period by at least 50 percentage points, (2) the change in stock ownership resulted from a purchase or a decrease in the amount of outstanding stock, and (3) the loss corporation failed to continue the conduct of a trade or business substantially the same as that conducted before the proscribed change in ownership (sec. 382(a)). An exception to the purchase rule was provided for acquisitions from related persons.

Tax-free reorganizations

After a tax-free reorganization to which section 382(b) applied, NOL carryovers were allowed in full under the 1954 Code so long as the loss corporation's shareholders received stock representing 20 percent or more of the value of the successor corporation (and section 269 did not apply). For each percentage point less than 20 percent received by the loss corporation's shareholders, the NOL carryover was reduced by five percent (e.g., if the loss corporation's shareholders received 15 percent of the acquiring corporation's stock, 25 percent of the NOL carryover was disallowed). The reorganizations described in section 382(b) were those referred to in section 381(a)(2), in which the loss corporation goes out of existence and NOL carryforwards carry over to a corporate successor. Where an acquiring corporation used stock of a parent corporation as consideration (in a triangular reorganization), the 20-percent test was applied by treating the loss corporation's shareholders as if they received stock of the acquiring corporation with an equivalent value, rather than stock of the parent corporation. An exception to the reorganization rule was provided for mergers of corporations that are owned substantially by the same persons in the same proportion (thus, the result in the *Libson Shops* case was reversed).

Bankruptcy proceedings and stock-for-debt exchanges

In the case of a G reorganization, a creditor who received stock in the reorganization was treated as a shareholder immediately before the reorganization. Thus, NOL carryforwards were generally available without limitation following changes in stock ownership resulting from a G reorganization.

If security holders exchanged securities for stock in a loss corporation, the transaction could qualify as an E reorganization or a section 351 exchange. If unsecured creditors (e.g., trade creditors) exchanged their debt claims for stock in a loss corporation, such creditors recognized gain or loss: (1) indebtedness of the transferee corporation not evidenced by a security was not considered as issued for property for purposes of section 351, and (2) the definition of an E reorganization required an exchange involving stock or securities. Thus, a stock-for-debt exchange by unsecured creditors was treated as a taxable purchase that triggered the special limitation.

Transactions involving "thrifts"

The general rules applied to taxable purchases of stock in a savings and loan association or savings bank (referred to as a "thrift"). Thus, after an ownership change resulting from a taxable purchase, a thrift's NOL carryforwards were unaffected if the thrift continued its business. Moreover, section 382 did not apply to a section 351 transfer to a thrift.

Where the acquisition of a thrift resulted from a reorganization described in section 368(a)(3)(D)(ii),[10] depositors were treated as stockholders and their deposits were treated as stock for purposes of the special limitations applicable to reorganizations (prior law sec. 382(b)(7)). Thus, a thrift's NOL carryforwards were unaffected if the depositors' interests (including the face amount of their deposits) represented at least 20 percent of the acquiring corporation's value after the merger.

Special Limitations on Other Tax Attributes

Section 383 incorporated by reference the same limitations contained in section 382 for carryforwards of investment credits, foreign tax credits, and capital losses.

[10] Prior law section 368(a)(3)(D)(ii) provided nonrecognition treatment to thrift reorganizations that would otherwise qualify as G reorganizations, provided the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC"), or an equivalent State authority certified that the thrift was insolvent, could not meet its obligations currently, or would be unable to meet its obligations in the immediate future.

1976 Act Amendments

The Tax Reform Act of 1976 extensively revised section 382 to provide more nearly parallel rules for taxable purchases and tax-free reorganizations and to address technical problems arising under the 1954 Code. The 1976 Act amendments were to be effective in 1978; however, the effective date was delayed several times. The 1976 Act amendments to the rule for purchases technically became effective for taxable years beginning after December 31, 1985. The amended reorganization rules technically became effective for reorganizations pursuant to plans adopted on or after January 1, 1986.

Reasons for Change

The Act draws heavily on the recommendations regarding limitations on NOL carryforwards that were made by the Finance Committee Staff as part of its comprehensive final report regarding reform of subchapter C of the Internal Revenue Code. (See S. Prt. 99-47, 99th Cong., 1st Sess. (1985), "The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff".)

Preservation of the Averaging Function of Carryovers

The primary purpose of the special limitations is the preservation of the integrity of the carryover provisions. The carryover provisions perform a needed averaging function by reducing the distortions caused by the annual accounting system. If, on the other hand, carryovers can be transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system. Under such a system, the Federal Government would effectively be required to reimburse a portion of all corporate tax losses. Regardless of the merits of such a reimbursement program, the carryover rules appear to be an inappropriate and inefficient mechanism for delivery of the reimbursement.

Appropriate Matching of Loss to Income

The 1976 Act amendments reflect the view that the relationship of one year's loss to another year's income should be largely a function of whether and how much the stock ownership changed in the interim, while the *Libson Shops* business continuation rule measures the relationship according to whether the loss and the income were generated by the same business. The Act acknowledges the merit in both approaches, while seeking to avoid the economic distortions and administrative problems that a strict application of either approach would entail.

A limitation based strictly on ownership would create a tax bias against sales of corporate businesses, and could prevent sales that would increase economic efficiency. For example, if a prospective buyer could increase the income from a corporate business to a moderate extent, but not enough to overcome the loss of all carryovers, no sale would take place because the business would be worth more to the less-efficient current owner than the prospective buyer would reasonably pay. A strict ownership limitation also would distort the measurement of taxable income generated by capital assets purchased before the corporation was acquired, if the tax deductions for capital costs economically allocable to post-acquisition years were accelerated into preacquisition years, creating carryovers that would be lost as a result of the acquisition.

Strict application of a business continuation rule would also be undesirable, because it would discourage efforts to rehabilitate troubled businesses. Such a rule would create an incentive to maintain obsolete and inefficient business practices if the needed changes would create the risk of discontinuing the old business for tax purposes, thus losing the benefit of the carryovers.

Permitting the carryover of all losses following an acquisition, as is permitted under the 1954 Code if the loss business is continued following a purchase, provides an improper matching of income and loss. Income generated under different corporate owners, from capital over and above the capital used in the loss business, is related to a pre-acquisition loss only in the formal sense that it is housed in the same corporate entity. Furthermore, the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions. For example, a prospective buyer of a loss corporation might be a less efficient operator of the business than the current owner, but the ability to use acquired losses could make the loss corporation more valuable to the less efficient user and thereby encourage a sale.

Reflecting the policies described above, the Act addresses three general concerns: (1) the approach of prior law (viz., the disallowance or reduction of NOL and other carryforwards), which is criticized as being too harsh where there are continuing loss-corporation shareholders, and ineffective to the extent that NOL carryforwards may be available for use without limitation after

substantial ownership changes, (2) the discontinuities in the prior law treatment of taxable purchases and tax-free reorganizations, and (3) defects in the prior law rules that presented opportunities for tax avoidance.

General Approach

After reviewing various options for identifying events that present the opportunity for a tax benefit transfer (e.g., changes in a loss corporation's business), it was concluded that changes in a loss corporation's stock ownership continue to be the best indicator of a potentially abusive transaction. Under the Act, the special limitations generally apply when shareholders who bore the economic burden of a corporation's NOLs no longer hold a controlling interest in the corporation. In such a case, the possibility arises that new shareholders will contribute income-producing assets (or divert income opportunities) to the loss corporation, and the corporation will obtain greater utilization of carryforwards than it could have had there been no change in ownership.

To address the concerns described above, the Act adopts the following approach: After a substantial ownership change, rather than reducing the NOL carryforward itself, the earnings against which an NOL carryforward can be deducted are limited. This general approach has received wide acceptance among tax scholars and practitioners. This "limitation on earnings" approach is intended to permit the survival of NOL carryforwards after an acquisition, while limiting the ability to utilize the carryforwards against unrelated income.

The limitation on earnings approach is intended to approximate the results that would occur if a loss corporation's assets were combined with those of a profitable corporation in a partnership. This treatment can be justified on the ground that the option of contributing assets to a partnership is available to a loss corporation. In such a case, only the loss corporation's share of the partnership's income could be offset by the corporation's NOL carryforward. Presumably, except in the case of tax-motivated partnership agreements, the loss corporation's share of the partnership's income would be limited to earnings generated by the assets contributed by the loss corporation.

For purposes of determining the income attributable to a loss corporation's assets, the Act prescribes an objective rate of return on the value of the corporation's equity. Consideration was given to the arguments made in favor of computing the prescribed rate of return by reference to the gross value of a loss corporation's assets, without regard to outstanding debt. It was concluded that it would be inappropriate to permit the use of NOL carryforwards to shelter earnings that are used (or would be used in the absence of an acquisition) to service a loss corporation's debt. The effect of taking a loss corporation's gross value into account would be to accelerate the rate at which NOL carryforwards would be used had there been no change in ownership, because interest paid on indebtedness is deductible in its own right (thereby deferring the use of a corresponding amount of NOLs). There is a fundamental difference between debt capitalization and equity capitalization: true debt represents a claim against a loss corporation's assets.

Annual limitation

The annual limitation on the use of pre-acquisition NOL carryforwards is the product of the prescribed rate and the value of the loss corporation's equity immediately before a proscribed ownership change. The average yield for long-term marketable obligations of the U.S. government was selected as the measure of a loss corporation's expected return on its assets.

The rate prescribed by the Act is higher than the average rate at which loss corporations actually absorb NOL carryforwards. Indeed, many loss corporations continue to experience NOLs, thereby increasing-rather than absorbing—NOL carryforwards. On the other hand, the adoption of the average absorption rate may be too restrictive for loss corporations that out-perform the average. Therefore, it would be inappropriate to set a rate at the lowest rate that is theoretically justified. The use of the long-term rate for Federal obligations was justified as a reasonable risk-free rate of return a loss corporation could obtain in the absence of a change in ownership.

Anti-abuse rules

The mechanical rules described above could present unintended tax-planning opportunities and might foster certain transactions that many would perceive to be violative of the legislative intent. Therefore, the Act includes several rules that are designed to prevent taxpayers from circumventing the special limitations or otherwise appearing to traffic in loss corporations by (1) reducing a loss corporation's assets to cash or other passive assets and then selling off a corporate shell consisting primarily of NOLs and cash or other passive assets, or (2) making pre-acquisition infusions of assets to inflate artificially a loss corporation's value (and thereby accelerate the use of NOL carryfor-

wards). In addition, the Act retains the prior law principles that are intended to limit tax-motivated acquisitions of loss corporations (e.g., section 269, relating to acquisitions to evade or avoid taxes, and the regulatory SRLY and CRCO rules).

Consideration also was given to transactions in which taxpayers effectively attempt to purchase the NOLs of a loss corporation by the use of a partnership in which the loss corporation, as a partner, is allocated a large percentage of taxable income for a limited time period. During this time, the NOL partner's losses are expected to shelter the partnership's income while the cash flow from the partnership's assets is used for other purposes. Later the NOL partner's share of income is reduced. When all the facts and circumstances are considered, including the arrangements and actual transactions with respect to capital accounts, it often appears to be questionable whether the economic benefit that corresponds to the initial special allocation to the NOL partner is fully received by such partner. Nevertheless, some taxpayers take the position that such allocations have substantial economic effect under section 704(b). The Act contemplates that the Treasury Department will review this situation under section 704(b).

The Act provides that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of section 382 through the use of related parties, pass-through entities, or other intermediaries. For example, regardless of whether a special allocation has substantial economic effect under section 704(b), special allocations of income to a loss partner, or other arrangements shifting taxable income, will not be permitted to result in a greater use of losses than would occur if the principles of section 382 were applied to the arrangement.

Technical Problems

The Act addresses the technical problems of prior law by (1) coordinating the rules for taxable purchases with the rules for tax-free transactions, (2) expanding the scope of the rules to cover economically similar transactions that effect ownership changes (such as capital contributions, section 351 exchanges, and B reorganizations), (3) refining the definition of the term "stock," and (4) applying the special limitations to built-in losses and taking into account built-in gains.

Discontinuities

Because the 1954 Code threshold for purchases was 50 percent, but the threshold for reorganizations was 20 percent, those rules presented the possibility that economically similar transactions would receive disparate tax treatment. Further, the special limitations applied after a purchase only if a pre-acquisition trade or business was discontinued, while the reorganization rule looked solely to changes in ownership. Finally, if the purchase rule applied, all NOL carryforwards were disallowed. In contrast, the rule for reorganizations merely reduced NOL carryforwards in proportion to the ownership change. The Act eliminates such discontinuities.

Continuity-of-business enterprise

The requirement under the 1954 Code rules that a loss corporation continue substantially the same business after a purchase presented potentially difficult definitional issues. Specifically, taxpayers and the courts were required to determine at what point a change in merchandise, location, size, or the use of assets should be treated as a change in the loss corporation's business. It was also difficult to identify a particular business where assets and activities were constantly combined, separated, or rearranged. Further, there was a concern that the prior law requirement induced taxpayers to continue uneconomic businesses.

The Act eliminates the business-continuation rule. The continuity-of-business-enterprise rule generally applicable to tax-free reorganizations also applies to taxable transactions.

Participating stock

The Act addresses the treatment of transactions in which the beneficial ownership of an NOL carryforward does not follow stock ownership. This problem is illustrated by the case of Maxwell Hardware Co., in which a loss corporation's old shareholders retained common stock representing more than 50 percent of the corporation's value, but new shareholders received specially tailored preferred stock that carried with it a 90-percent participation in the corporation's earnings attributable to income-producing assets contributed by the new shareholders.[11]

[11] 343 F.2d 713 (9th Cir. 1965).

Built-in gains and losses

Built-in losses should be subject to special limitations because they are economically equivalent to pre-acquisition NOL carryforwards. If built-in losses were not subject to limitations, taxpayers could reduce or eliminate the impact of the general rules by causing a loss corporation (following an ownership change) to recognize its built-in losses free of the special limitations (and then invest the proceeds in assets similar to the assets sold).

The Act also provides relief for loss corporations with built-in gain assets. Built-in gains are often the product of special tax provisions that accelerate deductions or defer income (e.g., accelerated depreciation or installment sales reporting). Absent a special rule, the use of NOL carryforwards to offset built-in gains recognized after an acquisition would be limited, even though the carryforwards would have been fully available to offset such gains had the gains been recognized before the change in ownership occurred. (Similarly, a partnership is required to allocate built-in gain or loss to the contributing partner.)

Although the special treatment of built-in gains and losses may require valuations of a loss corporation's assets, the Act limits the circumstances in which valuations will be required by providing a generous de minimis rule.

Other technical gaps

The Act also corrects the following defects in the 1954 Code rules: (1) only NOL deductions from prior taxable years were limited; thus, NOLs incurred in the year of a substantial ownership change were unaffected, (2) the rule for purchases was inapplicable to ownership changes resulting from section 351 exchanges, capital contributions, the liquidation of a partner's interest in a partnership that owns stock in a loss corporation, and nontaxable acquisitions of interests in a partnership (e.g., by contribution) that owns stock in a loss corporation, (3) the reorganization rule was inapplicable to B reorganizations, (4) the measurement of the continuing interest of a loss corporation's shareholders after a triangular reorganization enabled taxpayers to circumvent the 20-percent-continuity-of-interest rule, and (5) taxpayers took the position that the reorganization rule did not apply to reverse mergers (where an acquiring corporation's subsidiary merged into a loss corporation and the loss corporation's shareholders received stock of the acquiring corporation in the exchange).

Insolvent corporations

Under the general rule of the Act, no carryforwards would be usable after the acquisition of an insolvent corporation because the corporation's value immediately before the acquisition would be zero. In such a case, however, the loss corporation's creditors are the true owners of the corporation, although it may be impossible to identify the point in time when ownership shifted from the corporation's shareholders.[12] Relief from a strict application of the general rule is provided, as the creditors of an insolvent corporation frequently have borne the losses reflected in an NOL carryforward. There was a concern, however, about the potential for abusive transactions if an exception were generally available. For example, if there were a general stock-for-debt exception, an acquiring corporation could purchase a loss corporation's debt immediately before or during a bankruptcy proceeding, exchange the debt for stock without triggering the special limitations, and then use the loss corporation's NOL carryforwards immediately and without limitation. Alternatively, an acquiring corporation could purchase stock from the creditors after the bankruptcy proceeding, and after the loss corporation's value has been increased by capital contributions.

For these reasons, the Act provides an exception for ownership changes that occur as part of a G reorganization or a stock-for-debt exchange in a Title 11 or similar proceeding, but includes appropriate safeguards intended to tax-motivated acquisitions of debt issued by loss corporations.

Explanation of Provisions

Overview

The Act alters the character of the special limitations on the use of NOL carryforwards. After an ownership change, as described below, the taxable income of a loss corporation available for offset

[12] Cf. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) ("When the equity owners are excluded and the old creditors become the stockholders . . . , it conforms to reality to date [the creditors] equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority").

by pre-acquisition NOL carryforwards is limited annually to a prescribed rate times the value of the loss corporation's stock immediately before the ownership change. In addition, NOL carryforwards are disallowed entirely unless the loss corporation satisfies continuity-of-business enterprise requirements for the two-year period following any ownership change. The Act also expands the scope of the special limitations to include built-in losses and allows loss corporations to take into account built-in gains. The Act includes numerous technical changes and several anti-avoidance rules. Finally, the Act applies similar rules to carryforwards other than NOLs, such as net capital losses and excess foreign tax credits.

Ownership Change

The special limitations apply after any ownership change. An ownership change occurs, in general, if the percentage of stock of the new loss corporation owned by any one or more 5-percent shareholders (described below) has increased by more than 50 percentage points relative to the lowest percentage of stock of the old loss corporation owned by those 5-percent shareholders at any time during the testing period (generally a three-year period) (new sec. 382(g)(1)).[13] The determination of whether an ownership change has occurred is made by aggregating the increases in percentage ownership for each 5-percent shareholder whose percentage ownership has increased during the testing period. For this purpose, all stock owned by persons who own less than five percent of a corporation's stock generally is treated as stock owned by a single 5-percent shareholder (new sec. 382(g)(4)(A)). The determination of whether an ownership change has occurred is made after any owner shift involving a 5-percent shareholder or any equity structure shift.

Determinations of the percentage of stock in a loss corporation owned by any person are made on the basis of value. Except as provided in regulations to be prescribed by the Secretary, changes in proportionate ownership attributable solely to fluctuations in the relative fair market values of different classes of stock are not taken into account (new sec. 382(1)(3)(D)).

In determining whether an ownership change has occurred, changes in the holdings of certain preferred stock are disregarded. Except as provided in regulations, all "stock" (not including stock described in section 1504(a)(4)) is taken into account (new sec. 382(k)(6)(A)). Under this standard, the term stock does not include stock that (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's issue price upon issuance (except for a reasonable redemption premium), and (4) is not convertible to any other class of stock. If preferred stock carries a dividend rate materially in excess of a market rate, this may indicate that it would not be disregarded.

Under grants of regulatory authority, the Treasury Department is expected to publish regulations disregarding, in appropriate cases, certain stock that would otherwise be counted in determining whether an ownership change has occurred, when necessary to prevent avoidance of the special limitations (new sec. 382(k)(6)(B)). For example, it may be appropriate to disregard preferred stock (even though voting) or common stock where the likely percentage participation of such stock in future corporate growth is disproportionately small compared to the percentage value of the stock as a proportion of total stock value, at the time of the issuance or transfer. Similarly, there is a concern that the inclusion of voting preferred stock (which is not described in section 1504(a)(4) solely because it carries the right to vote) in the definition of stock presents the potential for avoidance of section 382. As another example, stock such as that issued to the old loss company shareholders and retained by them in the case of *Maxwell Hardware Company v. Commissioner*, 343 F.2d 716 (9th Cir. 1969), is not intended to be counted in determining whether an ownership change has occurred.

In addition, the Treasury Department will promulgate regulations regarding the extent to which stock that is not described in section 1504(a)(4) should nevertheless not be considered stock. For example, the Treasury Department may issue regulations providing that preferred stock otherwise described in section 1504(a)(4) will not be considered stock simply because the dividends are in arrears and the preferred shareholders thus become entitled to vote.

Owner Shift Involving a 5-Percent Shareholder

An owner shift involving a 5-percent shareholder is defined as any change in the respective ownership of stock of a corporation that affects the percentage of stock held by any person who holds five

[13] Unless specifically identified as a taxable year, all references to any period constituting a year (or multiple thereof) means a 365-day period (or multiple thereof).

percent or more of the stock of the corporation (a “5-percent shareholder”) before or after the change (new sec. 382(g)(2)). For purposes of this rule, all less-than-5-percent shareholders are aggregated and treated as one 5-percent shareholder. Thus, an owner shift involving a 5-percent shareholder includes (but is not limited to) the following transactions:

(1) A taxable purchase of loss corporation stock by a person who holds at least five percent of the stock before the purchase;

(2) A disposition of stock by a person who holds at least five percent of stock of the loss corporation either before or after the disposition;

(3) A taxable purchase of loss corporation stock by a person who becomes a 5-percent shareholder as a result of the purchase;

(4) A section 351 exchange that affects the percentage of stock ownership of a loss corporation by one or more 5-percent shareholders;

(5) A decrease in the outstanding stock of a loss corporation (e.g., by virtue of a redemption) that affects the percentage of stock ownership of the loss corporation by one or more 5-percent shareholders;

(6) A conversion of debt (or pure preferred stock that is excluded from the definition of stock) to stock where the percentage of stock ownership of the loss corporation by one or more 5-percent shareholders is affected; and

(7) An issuance of stock by a loss corporation that affects the percentage of stock ownership by one or more 5-percent shareholders.

Example 1. The stock of L corporation is publicly traded; no shareholder holds five percent or more of L stock. During the three-year period between January 1, 1987 and January 1, 1990, there are numerous trades involving L stock. No ownership change will occur as a result of such purchases, provided that no person (or persons) becomes a 5-percent shareholder, either directly or indirectly, and increases his (or their) ownership of L stock by more than 50 percentage points.

Example 2. On January 1, 1987, the stock of L corporation is publicly traded; no shareholder holds five percent or more of L stock. On September 1, 1987, individuals A, B, and C, who were not previously L shareholders and are unrelated to each other or any L shareholders each acquire one-third of L stock. A, B, and C each have become 5-percent shareholders of L and, in the aggregate, hold 100 percent of the L stock. Accordingly, an ownership change has occurred, because the percentage of L stock owned by the three 5-percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by A, B, and C at any time during the testing period (0 percent prior to September 1, 1987).

Example 3. On January 1, 1987, individual I owns all 1,000 shares of corporation L. On June 15, 1987, I sells 300 of his L shares to unrelated individual A. On June 15, 1988, L issues 100 shares to each of B, C, and D. After these owner shifts involving I, A, B, C, and D, each of whom is a 5-percent shareholder, there is no ownership change, because the percentage of stock owned by A, B, C, and D after the owner shifts (approximately 46 percent-A 23 percent; B, C, and D 7.7 percent each) has not increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders during the testing period (0 percent prior to June 15, 1987). On December 15, 1988, L redeems 200 of the shares owned by I. Following this owner shift affecting I, a 5-percent shareholder, there is an ownership change, because the percentage of L stock owned by A, B, C, and D (approximately 55 percent-A-27.3 percent; B, C, and D-9.1 percent each) has increased by more than 50 percentage points over the lowest percentage owned by those shareholders during the testing period (0 percent prior to June 15, 1987).

Example 4. L corporation is closely held by four unrelated individuals, A, B, C, and D. On January 1, 1987, there is a public offering of L stock. No person who acquires stock in a public offering acquires five percent or more, and neither A, B, C, nor D acquires any additional stock. As a result of the offering, less-than-5-percent shareholders own stock representing 80 percent of the outstanding L stock. The stock ownership of the less-than-5-percent shareholders are aggregated and treated as owned by a single 5-percent shareholder for purposes of determining whether an ownership change has occurred. The percentage of stock owned by the less-than-5-percent shareholders after the owner shift (80 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the testing period (0 percent prior to January 1, 1987). Thus, an ownership change has occurred.

Example 5. On January 1, 1987, L corporation is wholly owned by individual X. On January 1, 1988, X sells 50 percent of his stock to 1,000 shareholders, all of whom are unrelated to him. On January 1, 1989, X sells his remaining 50-percent interest to an additional 1,000 shareholders, all of whom also are unrelated to him. Based on these facts, there is not an ownership change immediately fol-

lowing the initial sales by X, because the percentage of L stock owned by the group of less-than-5-percent shareholders (who are treated as a single 5-percent shareholder) after the owner shift (50 percent) has not increased by more than 50 percentage points over the lowest percentage of stock owned by this group at any time during the testing period (0 percent prior to January 1, 1988). On January 1, 1989, however, there is an ownership change, because the percentage of L stock owned by the group of less-than-5-percent shareholders after the owner shift (100 percent) has increased by more than 50 percentage points over their lowest percentage ownership at any time during the testing period (0 percent prior to January 1, 1988).

Example 6. The stock of L corporation is publicly traded; no shareholder owns five percent or more. On January 1, 1987, there is a stock offering as a result of which stock representing 60 percent of L's value is acquired by an investor group consisting of 12 unrelated individuals, each of whom acquires five percent of L stock. Based on these facts, there has been an ownership change, because the percentage of L stock owned after the owner shift by the 12 5-percent shareholders in the investor group (60 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the testing period (0 percent prior to January 1, 1987).

Example 7. On January 1, 1987, L corporation is owned by two unrelated shareholders, A (60 percent) and C (40 percent). LS corporation is a wholly owned subsidiary of L corporation and is therefore deemed to be owned by A and C in the same proportions as their ownership of L (after application of the attribution rules, as discussed below). On January 1, 1988, L distributes all the stock of LS to A in exchange for all of A's L stock in a section 355 transaction. There has been an ownership change of L, because the percentage of L stock owned by C (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by C at any time during the testing period (40 percent prior to the distribution of LS stock). There has not been an ownership change of LS, because the percentage of stock owned by A (100 percent) has not increased by more than 50 percentage points over the lowest percentage of stock owned by A at any time during the testing period (60 percent, after application of the attribution rules, as discussed below), prior to January 1, 1988.

An equity structure shift is defined as any tax-free reorganization within the meaning of section 368, other than a divisive "D" or "G" reorganization or an "F" reorganization (new sec. 382(g)(3)(A)). In addition, to the extent provided in regulations, the term equity structure shift may include other transactions, such as public offerings not involving a 5-percent shareholder or taxable reorganization-type transactions (e.g., mergers or other reorganization-type transactions that do not qualify for tax-free treatment due to the nature of the consideration or the failure to satisfy any of the other requirements for a tax-free transaction) (new secs. 382(g)(3)(B), (g)(4), and (m)(5)).[14] A purpose of the provision that considers only owner shifts involving a 5-percent shareholder is to relieve widely held companies from the burden of keeping track of trades among less-than-5-percent shareholders. For example, a publicly traded company that is 60 percent owned by less-than-5-percent shareholders would not experience an ownership change merely because, within a three-year period, every one of such shareholders sold his stock to a person who was not a 5-percent shareholder. There are situations involving transfers of stock involving less-than-5-percent shareholders, other than tax-free reorganizations (for example, public offerings), in which it will be feasible to identify changes in ownership involving such shareholders, because, unlike public trading, the changes occur as part of a single, integrated transaction. Where identification is reasonably feasible or a reasonable presumption can be applied, the Treasury Department is expected to treat such transactions under the rules applicable to equity structure shifts.

For purposes of determining whether an ownership change has occurred following an equity structure shift, the less-than-5-percent shareholders of each corporation that was a party to the reorganization will be segregated and treated as a single, separate 5-percent shareholder (new sec. 382(g)(4)(B)(i)). The Act contemplates that this segregation rule will similarly apply to acquisitions by groups of less-than-5-percent shareholders through corporations as well as other entities (e.g., partnerships) and in transactions that do not constitute equity structure shifts (new sec. 382(g)(4)(C)). Moreover, the Act provides regulatory authority to apply similar segregation rules to

[14] The regulatory authority provided by section 382(g)(3)(B) should not be construed to limit the scope of section 382(g)(4)(C), as augmented by section 382(m)(5). *See* discussion in text following Example 8 *supra*.

segregate groups of less-than-5-percent shareholders in cases that involve only a single corporation (for example, a public offering or a recapitalization). (New sec. 382(m)(5)).

Example 8. On January 1, 1988, L corporation (a loss corporation) is merged (in a transaction described in section 368(a)(1)(A)) into P corporation (not a loss corporation), with P surviving. Both L and P are publicly traded corporations with no shareholder owning five percent or more of either corporation or the surviving corporation. In the merger, L shareholders receive 30 percent of the stock of P. There has been an ownership change of L, because the percentage of P stock owned by the former P shareholders (all of whom are less-than-5-percent shareholders who are treated as a separate, single 5-percent shareholder) after the equity structure shift (70 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the merger). If, however, the former shareholders of L had received at least 50 percent of the stock of P in the merger, there would not have been an ownership change of L.

An ownership change would similarly occur after a taxable merger in which L acquires P (in which L's losses are not affected other than by the special limitations), if L's former shareholders receive only 30 percent of the combined company, pursuant to new section 382(g)(4)(C). The Congress expected that section 382(g)(4)(C) would by its terms generally cause the segregation of the less-than-5-percent shareholders of separate entities where an entity other than a single corporation is involved in a transaction. Section 382(g)(3)(B) and section 382(m)(5) provide additional authority for the Treasury to segregate groups of less-than-5-percent shareholders where there is only one corporation involved.

Example 9. January 1, 1987, L corporation is owned by two unrelated shareholders, A (60 percent) and C (40 percent). On January 1, 1988, L redeems all of A's L stock in exchange for non-voting preferred stock described in section 1504(a)(4). Following this recapitalization (which is both an equity structure shift and an owner shift involving a 5-percent shareholder), there has been an ownership change of L, because the percentage of L stock (which does not include preferred stock within the meaning of section 1504(a)(4)) owned by C following the equity structure shift (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by C at any time during the testing period (40 percent prior to the recapitalization).

Assume, alternatively, that on January 1, 1987, the stock of L corporation was widely held, with no shareholder owning as much as five percent, and that 60 percent of the stock was redeemed in exchange for non-voting preferred stock in a transaction that is otherwise identical to the transaction described above (which would be an equity structure shift, but not an owner shift involving a 5-percent shareholder because of the existence of only a single 5-percent shareholder, the aggregated less-than-5-percent shareholders, who owns 100 percent of L both before and after the exchange). In such a case, the Secretary will prescribe regulations segregating the less-than-5-percent shareholders of the single corporation, so that the group of shareholders who retain common stock in the recapitalization will be treated as a separate, single 5-percent shareholder. Accordingly, such a transaction would constitute an ownership change, because the percentage of L stock owned by the continuing common shareholders (100 percent) has increased by more than 50 percentage points over the lowest percent of stock owned by such shareholders at any time during the testing period (40 percent prior to the recapitalization).

Example 10. L corporation stock is widely held; no shareholder owns as much as five percent of L stock. On January 1, 1988, L corporation, which has a value of $1 million, directly issues stock with a value of $2 million to the public; no one person acquired as much as five percent in the public offering. No ownership change has occurred, because a public offering in which no person acquires as much as five percent of the corporation's stock, however large, by a corporation that has no five-percent shareholder before the offering would not affect the percentage of stock owned by a 5-percent shareholder.[15] In other words, the percentage of stock owned by less-than-5-percent shareholders of L immediately after the public offering (100 percent) has not increased by more than 50 percentage points over the lowest percentage of stock owned by the less-than-5-percent shareholders of L at any time during the testing period (100 percent).

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[15] A different result would occur if the public offering were performed by an underwriter on a "firm commitment" basis, because the underwriter would be a 5-percent shareholder whose percentage of stock (66.67 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by the underwriter at any time during the testing period (0 percent prior to public offering). *See* Rev. Rul. 78-294, 1978-2 C.B. 141.

To the extent provided in regulations that will apply prospectively from the date the regulations are issued, a public offering can be treated, in effect, as an equity structure shift with the result that the offering is a measuring event, even if there is otherwise no change in ownership of a person who owns 5-percent of the stock before or after the transaction. Rules also would be provided to segregate the group of less-than-5-percent shareholders prior to the offering and the new group of less-than-5-percent shareholders that acquire stock pursuant to the offering. Under such regulations, therefore, the less-than-5-percent shareholders who receive stock in the public offering could be segregated and treated as a separate 5-percent shareholder. Thus, an ownership change may result from the public offering described above, because the percentage of stock owned by the group of less-than-5-percent shareholders who acquire stock in the public offering, who are treated as a separate 5-percent shareholder (66.67 percent), has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the public offering). The Act contemplates that the regulations may provide rules to allow the corporation to establish the extent, if any, to which existing shareholders acquire stock in the public offering.

Multiple Transactions

As described above, the determination of whether an ownership change has occurred is made by comparing the relevant shareholders' stock ownership immediately after either an owner shift involving a 5-percent shareholder or an equity structure shift with the lowest percentage of such shareholders' ownership at any time during the testing period. Thus, changes in ownership that occur by reason of a series of transactions including both owner shifts involving a 5-percent shareholder and equity structure shifts may constitute an ownership change. Where the segregation rule applies, for purposes of determining whether an ownership change has occurred as a result of any transaction, the acquisition of stock shall be treated as being made proportionately from all the shareholders immediately before the acquisition, unless a different proportion is established (new section 382(g)(4)(B)(ii) and (C)).

Example 11. On January 1, 1988, I (an individual) purchased 40 percent of the stock of L. The remaining stock of L is owned by 25 shareholders, none of whom own as much as five percent. On July 1, 1988, L is merged into P—which is wholly owned by I—in a tax-free reorganization. In exchange for their stock in L, the L shareholders (immediately before the merger) receive stock with a value representing 60 percent of the P stock that is outstanding immediately after the merger (24 percent to I; 36 percent to the less-than-5-percent shareholders of L). No other transactions occurred with respect to L stock during the testing period preceding the merger. There is an ownership change with respect to L immediately following the merger, because the percentage of stock owned by I in the combined entity (64 percent-40 percent by virtue of I's ownership of P prior to the merger plus 24 percent received in the merger) has increased by more than 50 percentage points over the lowest percentage of stock in L owned by I during the testing period (0 percent prior to January 1, 1988).

Example 12. On July 12, 1989, L corporation is owned 45 percent by P, a publicly traded corporation (with no 5-percent shareholders), 40 percent by individual A, and 15 percent by individual B. All of the L shareholders have owned their stock since L's organization in 1984. Neither A nor B owns any P stock. On July 30, 1989, B sells his entire 15-percent interest to C for cash. On August 13, 1989, P acquires A's entire 40-percent interest in exchange for P stock representing an insignificant percentage of the outstanding P voting stock in a "B" reorganization.

There is an ownership change immediately following the B reorganization, because the percentage of L stock held (through attribution, as described below) by P shareholders (all of whom are less-than-5-percent shareholders who are treated as one 5-percent shareholder) and C (100 percent—P shareholders-85 percent; C-15 percent) has increased by more than 50 percentage points over the lowest percentage of stock owned by P shareholders and C at any time during the testing period (45 percent held constructively by P shareholders prior to August 13, 1989).

Example 13. The stock of L corporation is widely held by the public; no single shareholder owns five percent or more of L stock. G corporation also is widely held with no shareholder owning five percent or more. On January 1, 1988, L corporation and G corporation merge (in a tax-free transaction), with L surviving, and G shareholders receive 49 percent of L stock. On July 1, 1988, B, an individual who has never owned stock in L or G, purchases five percent of L stock in a transaction on a public stock exchange.

The merger of L and G is not an ownership change of L, because the percentage of stock owned by the less-than-5-percent shareholders of G (who are aggregated and treated as a single 5-percent

shareholder) (49 percent) has not increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders during the testing period (0 percent prior to the merger). The purchase of L stock by B is an owner shift involving a five-percent shareholder, which is presumed (unless otherwise established) to have been made proportionately from the groups of former G and L shareholders (49 percent from the G shareholders and 51 percent from the L shareholders). There is an ownership change of L because, immediately after the owner shift involving B, the percentage of stock owned by the G shareholders (presumed to be 46.55 percent—49 percent actually acquired in the mergerless 2.45 percent presumed sold to B) and B (5 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by those shareholders at any time during the testing period (0 percent prior to the merger).

Example 14. The stock of L corporation and G corporation is widely held by the public; neither corporation has any shareholder owning as much as five percent of its stock. On January 1, 1988, B purchases 10 percent of L stock. On July 1, 1988, L and G merge (in a tax-free transaction), with L surviving, and G shareholders receiving 49 percent of L stock.

The merger of L and G is an ownership change because, immediately after the merger, the percentage of stock owned by G shareholders (49 percent) and B (5.1 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by such shareholders at any time during the testing period (0 percent prior to the stock purchase by B).

Attribution and Aggregation of Stock Ownership

Attribution from entities. In determining whether an ownership change has occurred, the constructive ownership rules of section 318, with several modifications, are applied (new sec. 382(1)(3)). Except to the extent provided in regulations, the rules for attributing ownership of stock (within the meaning of new section 382(k)(6)) from corporations to their shareholders are applied without regard to the extent of the shareholders' ownership in the corporation.[16] Thus, any stock owned by a corporation is treated as being owned proportionately by its shareholders. Moreover, except as provided in regulations, any stock attributed to a corporation's shareholders is not treated as being held by such corporation. Stock attributed from a partnership, estate, or trust similarly shall not be treated as being held by such entity. The effect of the attribution rules is to prevent application of the special limitations after an acquisition that does not result in a more than 50 percent change in the ultimate beneficial ownership of a loss corporation.[17] Conversely, the attribution rules result in an ownership change where more than 50 percent of a loss corporation's stock is acquired indirectly through an acquisition of stock in the corporation's parent corporation.

Example 15. L corporation is publicly traded; no shareholder owns as much as five percent. P corporation is publicly traded; no shareholder owns as much as five percent. On January 1, 1988, P corporation purchases 100 percent of L corporation stock on the open market. The L stock owned by P is attributed to the shareholders of P, all of whom are less-than-5-percent shareholders who are treated as a single, separate 5-percent shareholder under section 382(g)(4)(C). Accordingly, there has

[16] The attribution rules apply to stock or other interests in a manner consistent with the basic definition of an ownership change under the Act. Thus, section 318 is applied only to "stock" that is taken into account for purposes of section 382. For example, assume a corporation owns both common stock and stock described in section 1504(a)(4) of a type which is not counted in determining whether there has been an ownership change (referred to as "pure preferred") in a holding company. The pure preferred represents 55 percent of the holding company's value. The holding company's only asset consists of 100 percent of the common stock—the only class outstanding—in an operating subsidiary that is a loss corporation. The sale of the pure preferred would not constitute an ownership change because no stock in the loss corporation may be attributed through such stock. On the other hand, assume 100 percent of the stock in a loss corporation is transferred in a section 351 exchange, in which the loss corporation's sole shareholder receives pure preferred representing 51 percent of the transferee's value, and an unrelated party receives 100 percent of the transferee's common stock. Here, an ownership change would result with respect to the loss corporation.

Similar rules would apply where a loss corporation is owned directly or indirectly by a partnership (or other intermediary) that has outstanding ownership interests substantially similar to a pure preferred stock interest.

[17] The Act contemplates that regulations may provide rules to allow a widely held loss corporation to establish the extent, if any, to which there is overlapping stock ownership between an acquiring widely held corporation and such loss corporation.

been an ownership change of L, because the percentage of stock owned by the P shareholders after the purchase (100 percent) has increased by more than 50 percentage points over the lowest percentage of L stock owned by that group at any time during the testing period (0 percent prior to January 1, 1988).

Aggregation rules. Special aggregation rules are applied for all stock ownership, actual or deemed, by shareholders of a corporation who are less-than-5-percent shareholders. Except as provided in regulations, stock owned by such persons is treated as being held by a single, separate 5-percent shareholder. For purposes of determining whether transactions following an equity structure shift or owner shift involving a 5-percent shareholder constitute an ownership change, the aggregation rules trace any subsequent change in ownership by a group of less-than-5-percent shareholders. In analyzing subsequent shifts in ownership, unless a different proportion is established otherwise, acquisitions of stock shall be treated as being made proportionately from all shareholders immediately before such acquisition.

Example 16. Corporation A is widely held by a group of less-than-5-percent shareholders ("Shareholder Group A"). Corporation A owns 80 percent of both corporation B and corporation C, which respectively own 100 percent of corporation L and corporation P. Individual X owns the remaining stock in B (20 percent) and individual Y owns the remaining stock in C (20 percent). On January 1, 1988, L and P are, respectively, the only assets of B and C; and B and C are of equal value. On January 1, 1988, B merges into C with C surviving. After the merger, X owns 10 percent of C stock, Y owns 10 percent of C stock, and A owns 80 percent of C stock. The attribution rules (see sec. 382(1)(3)) and special aggregation rules (see sec. 382(g)(4)) apply to treat Shareholder Group A as a single, separate 5-percent shareholder owning 80 percent of the stock of L prior to the merger. Following the merger, Shareholder Group A still owns 80 percent of the stock of L, X owns 10 percent of the stock of L, and Y owns 10 percent of the stock of L. No ownership change occurs as a result of the merger, because the stock of L owned by Shareholder Group A is the same before and after the merger (80 percent), the stock of L owned by X has not increased but has decreased, and the stock of L owned by Y (0 percent before the merger and 10 percent after the merger) has not increased by more than 50 percentage points.

Example 17. L corporation is publicly traded; no shareholder owns more than five percent. LS is a wholly owned subsidiary of L corporation. On January 1, 1988, L distributes all the stock of LS pro rata to the L shareholders. There has not been any change in the respective ownership of the stock of LS, because the less-than-5-percent shareholders of L, who are aggregated and treated as a single, separate 5-percent shareholder, are treated as owning 100 percent of LS (by attribution) before the distribution and directly own 100 percent of LS after the distribution. Thus, no owner shift involving a 5-percent shareholder has occurred; accordingly, there has not been an ownership change.

Example 18. L Corporation is valued at $600. Individual A owns 30 percent of L stock, with its remaining ownership widely held by less-than-5-percent shareholders ("Shareholder Group L"). P corporation is widely held by less-than-5-percent shareholders ("Shareholder Group P"), and is valued at $400. On January 1, 1988, L and P consolidate in a tax-free reorganization into L/P Corporation, with 60 percent of the value of such stock being distributed to former L corporation shareholders. On June 15, 1988, 17 percent of L/P corporation stock is acquired in a series of open market transactions by individual B. At all times between January 1, 1988 and June 15, 1988, A's ownership interest in L/P Corporation remained unchanged.

The consolidation by L and P on January 1, 1988 is an equity structure shift, but not an ownership change with respect to L. Under the attribution and aggregation rules, the ownership interest in new loss corporation, L/P Corporation, is as follows: A owns 18 percent (60 percent of 30 percent), Shareholder Group L owns 42 percent (60 percent of 70 percent) and Shareholder Group P owns 40 percent. The only 5-percent shareholder whose stock interest in new loss corporation increased relative to the lowest percentage of stock ownership in old loss corporation during the testing period, Shareholder Group P, did not increase by more than 50 percentage points.

The Act provides that, unless a different proportion is established by the taxpayer or the Internal Revenue Service, acquisitions of stock following the consolidation are treated as being made proportionately from all shareholders immediately before such transaction. Thus, under the general rule, B's open market purchase on June 15, 1988 of L/P Corporation stock would be treated as being made proportionately from A, Shareholder Group L, and Shareholder Group P. As a result, the application of this convention without modification would result in an ownership change, because the interests of B (17 percent) and Shareholder Group P (40 percent less the 6.8 percent deemed acquired by B) in new loss corporation would have increased by more than 50 percentage points during the testing period (50.2 percent). A's ownership interest in L/P corporation, however, has in

fact remained unchanged. Because L/P Corporation could thus establish that the acquisition by B was not proportionate from all existing shareholders, however, it would be permitted to establish a different proportion for the deemed shareholder composition following B's purchase as follows: (1) A actually owns 18 percent, (2) B actually owns 17 percent, (3) Shareholder Group L is deemed to own 33.3 percent (42 percent less (17 percent × 42/82)), and (4) Shareholder Group P is deemed to own 31.7 percent (40 percent less (17 percent × 40/82)). If L/P Corporation properly establishes these facts, no ownership change has occurred, because B and Shareholder Group P have a stock interest in L/P Corporation (48.7 percent) that has not increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders in L/P Corporation, or L Corporation at any time during the testing period (0 percent).

If B purchased eleven percent from A, there would be an ownership change. The presumption does not apply in the case of subsequent purchases from persons who are 5-percent shareholders without regard to the aggregation rules.

Other attribution rules. The family attribution rules of sections 318(a)(1) and 318(a)(5)(B) do not apply, but an individual, his spouse, his parents, his children, and his grandparents are treated as a single shareholder. "Back" attribution to partnerships, trusts, estates, and corporations from partners, beneficiaries, and shareholders will not apply except as provided in regulations.

The Act does not provide rules for attributing stock that is owned by a government. For example, stock that is owned by a foreign government is not treated as owned by any other person. Thus, if a government of a country owned 100% of the stock of a corporation and, within the testing period, sold all of such stock to members of the public who were citizens of the country, an ownership change would result. Governmental units, agencies, and instrumentalities that derive their powers, rights, and duties from the same sovereign authority will be treated as a single shareholder.

Finally, except as provided in regulations, the holder of an option is treated as owning the underlying stock if such a presumption would result in an ownership change.[18] This rule is intended to apply to options relating to stock in a loss corporation as well as any other instrument relating to the direct or indirect ownership in a loss corporation. The subsequent exercise of an option is disregarded if the holder of the option has been treated as owning the underlying stock. On the other hand, if the holder of the option was not treated as owning the underlying stock, the subsequent exercise will be taken into account in determining whether there is an owner shift at time of exercise. This rule is to be applied on an option-by-option basis so that, in appropriate cases, certain options will be deemed exercised while others may not. Similarly, a person will be treated as owning stock that may be acquired pursuant to any contingency, warrant, right to acquire stock, conversion feature, put, or similar interest, if such a presumption results in an ownership change.[19] If the option or other contingency expires without a transfer of stock ownership, but the existence of the option or other contingency resulted in an ownership change under this rule, the loss corporation will be able to file amended tax returns (subject to any applicable statute of limitations) for prior years as if the corporation had not been subject to the special limitations.

Example 19. L corporation has 1,000 shares of stock outstanding, which are owned by 25 unrelated shareholders, none of whom own five percent or more. P corporation is wholly owned by indi-

[18] Thus, except as provided in regulations, the stock underlying an option or other interest subject to the rule in section 382(1)(3)(A)(iv) may be taken into account on and after the date on which the interest is acquired or is later transferred, for purposes of determining whether an ownership change occurs following any transaction (including such acquisition of transfer). It is expected that the Treasury Department may consider whether there are circumstances in which it may be appropriate to limit the operation of this rule to transactions occurring during any three-year period that includes the date the option or other interest is issued or transferred.

[19] The types of rights to acquire stock that are subject to this rule thus may extend beyond those rights that have been treated as options under section 318(a)(4) as applied for other purposes. For example, it is intended that a right to acquire unissued stock of a corporation would (except as provided in regulations) be treated as exercised if an ownership change would result, without regard to how such a right may have been treated under section 318(a)(4). Compare Rev. Rul. 68-601, 1968-2 C.B. 124; *J. Milton Sorem v. Commissioner*, 335 F.2d 275 (10th Cir. 1964); *W.H. Bloch v. United States*, 261 F. Supp. 597 (S.D. Tex. 1967), *aff'd per curiam*, 386 F.2d 531 (5th Cir. 1968). It is expected that Treasury will exercise its regulatory authority, however, to prevent the use of this rule in appropriate cases—as one example, where options or other interests subject to the rule are issued shortly after a corporation has incurred a de minimis amount of loss.

vidual A. On January 1, 1987, L corporation acquires 100 percent of P stock from A. In exchange, A receives 750 shares of L stock and a contingent right to receive up to an additional 500 shares of L stock, depending on the earnings of P corporation over the next five years.

Except as provided in regulations, A would be treated as owning all the L stock that he might receive on occurrence of the contingency (and such stock is thus treated as additional outstanding stock). Accordingly, an ownership change of L would occur, because the percentage of stock owned (and treated as owned) by A (1.250 shares-55.5 percent (33.3 percent (750 of 2,250 shares) directly and 22.2 percent (500 of 2,250 shares) by attribution)) increased by more than 50 percentage points over the lowest percentage of stock owned by A at any time during the testing period (0 percent prior to January 1, 1987).

Example 20. L corporation and P corporation are publicly traded; no shareholder owns five percent or more of either corporation. On January 1, 1989, P corporation purchases 40 percent of the stock in L corporation and an option to acquire the remaining 60 percent of L corporation stock. The option is exercisable three years after the date on which the option is issued.

Under the Act, if P is treated as owning the L corporation stock obtainable on exercise of the option, then P corporation would be treated as owning 100 percent of L corporation. Thus, the presumption provided by section 382(1)(3)(A) would apply, and an ownership change would result. The same result would apply even if the option were exercisable only in the event of a contingency such as the attaining of a specified earnings level by the end of a specified period.

Stock acquired by reason of death, gift, divorce or separation. If (i) the basis of any stock in the hands of any person is determined under section 1014 (relating to property acquired from a decedent), section 1015 (relating to property acquired by a gift or transfer in trust), or section 1041(b) (relating to transfers of property between spouses or incident to divorce), (ii) stock is received by any person in satisfaction of a right to receive a pecuniary bequest, or (iii) stock is acquired by a person pursuant to any divorce or separation instrument (within the meaning of section 71(b)(2)), then such persons shall be treated as owning such stock during the period such stock was owned by the person from whom it was acquired (new sec. 382(1)(3)(B)). Such transfers, therefore, would not constitute owner shifts.

Special rule for employee stock ownership plans. If certain ownership and allocation requirements are satisfied, the acquisition of employer securities (within the meaning of section 409(1)) by either a tax credit employee stock ownership plan or an employee stock ownership plan (within the meaning of section 4975(e)(7)) shall not be taken into account in determining whether an ownership change has occurred (new sec. 382(1)(3)(C)). The acquisition of employer securities from any such plan by a participant of any such plan pursuant to the requirements of section 409(h) also will not be taken into account in determining whether an ownership change has occurred.

Utilization of holding company structures. The mere formation of a holding company unaccompanied by a change in the beneficial ownership of the loss corporation will not result in an ownership change. The attribution rules of section 318, as modified for purposes of applying these special limitations, achieve this result by generally disregarding any corporate owner of stock as the owner of any loss corporation stock (new sec. 382(1)(3)(A)(ii)(II)). Instead, the attribution rules are designed to provide a mechanism for tracking the changes in ownership by the ultimate beneficial owners of the loss corporation. The creation of a holding company structure is significant to the determination of whether an ownership change has occurred only if it is accompanied by a change in the ultimate beneficial ownership of the loss corporation.

Example 21. The stock of L corporation is owned equally by unrelated individuals, A, B, C, and D. On January 1, 1988, A, B, C, and D contribute their L corporation stock to a newly formed holding company ("HC") in exchange for equal interests in stock and securities of HC in a transaction that qualifies under section 351.

The formation of HC does not result in an ownership change with respect to L. Under the attribution rules, A, B, C, and D following the incorporation of L corporation are considered to own 25 percent of the stock of L corporation and, unless provided otherwise in regulations, HC is treated as not holding any stock in L corporation. Accordingly, the respective holdings in L corporation were not altered to any extent and there is thus no owner shift involving a 5-percent shareholder. The result would be the same if L corporation were owned by less-than-5-percent shareholders prior to the formation of the holding company.

Example 22. The stock of L corporation is widely held by the public ("Public/L") and is valued at $600. P is also widely held by the public ("Public/P") and is valued at $400. On January 1, 1988, P forms Newco with a contribution of P stock. Immediately thereafter, Newco acquires all of the properties of L corporation in exchange for its P stock in a forward triangular merger qualifying under

section 368(a)(2)(D). Following the transaction, Public/L and Public/P respectively are deemed to own 60 percent and 40 percent of P stock.

Inserting P between Public/L and L corporation (which becomes Newco in the merger) does not result in an ownership change with respect to Newco, the new loss corporation. Under new section 382(g)(4)(B)(i), Public/L and Public/P are each treated as a separate 5-percent shareholder of Newco, the new loss corporation.[20] Unless regulations provide otherwise, P's direct ownership interest in L corporation is disregarded. Because the percentage of Newco stock owned by Public/P shareholders after the equity structure shift (40 percent) has not increased by more than 50 percentage points over the lowest percentage of stock of L (the old loss corporation) owned by such shareholders at any time during the testing period (0 percent prior to January 1, 1988), the transaction does not constitute an ownership change with respect to Newco.

3-Year Testing Period

In general, the relevant testing period for determining whether an ownership change has occurred is the three-year period preceding any owner shift involving a 5-percent shareholder or any equity structure shift (new sec. 382(i)(1)). Thus, a series of unrelated transactions occurring during a three-year period may constitute an ownership change. A shorter period, however, may be applicable following any ownership change. In such a case, the testing period for determining whether a second ownership change has occurred does not begin before the day following the first ownership change (new sec. 382(i)(2)).

In addition, the testing period does not begin before the first day of the first taxable year from which there is a loss carryforward (including a current NOL that is defined as a pre-change loss) or excess credit (new sec. 382(i)(3)). Thus, transactions that occur prior to the creation of any attribute subject to limitation under section 382 or section 383 are disregarded. Except as provided in regulations, the special rule described above does not apply to any corporation with a net unrealized built-in loss. The Act contemplates, however, that the regulations will permit such corporations to disregard transactions that occur before the year for which such a corporation establishes that a net unrealized built-in loss first arose.

Effect of Ownership Change

Section 382 limitation

For any taxable year ending after the change date (i.e., the date on which an owner shift resulting in an ownership change occurs or the date of the reorganization in the case of an equity structure shift resulting in an ownership change), the amount of a loss corporation's (or a successor corporation's) taxable income that can be offset by a pre-change loss (described below) cannot exceed the section 382 limitation for such year (new sec. 382(a)). The section 382 limitation for any taxable year is generally the amount equal to the value of the loss corporation immediately before the ownership change multiplied by the long-term tax-exempt rate (described below) (new sec. 382(b)(1)).

The Treasury Department is required to prescribe regulations regarding the application of the section 382 limitation in the case of a short taxable year. These regulations will generally provide that the section 382 limitation applicable in a short taxable year will be determined by multiplying the full section 382 limitation by the ratio of the number of days in the year to 365. Thus, taxable income realized by a new loss corporation during a short taxable year may be offset by pre-change losses not exceeding a ratable portion of the full section 382 limitation.

If there is a net unrealized built-in gain, the section 382 limitation for any taxable year is increased by the amount of any recognized built-in gains (determined under rules described below). Also, the section 382 limitation is increased by built-in gain recognized by virtue of a section 338 election (to the extent such gain is not otherwise taken into account as a built-in gain). Finally, if the section 382 limitation for a taxable year exceeds the taxable income for the year, the section 382 limitation for the next taxable year is increased by such excess.

[20] The rules described above aggregate all less-than-5-percent shareholders of any corporation. These aggregation rules are to be applied after taking into account the attribution rules. In the above example, the old loss corporation and new loss corporation are properly treated as the same corporation. Thus, even though L does not survive the reorganization, Public/L is properly treated as a continuing 5-percent shareholder of Newco, the new loss corporation. The same result would be appropriate if the transaction had been structured as a reverse triangular merger under section 368(a)(2)(E).

If two or more loss corporations are merged or otherwise reorganized into a single entity, separate section 382 limitations are determined and applied to each loss corporation that experiences an ownership change.

Example 23. X corporation is wholly owned by individual A and its stock has a value of $3,000; X has NOL carryforwards of $10,000. Y corporation is wholly owned by individual B and its stock has a value of $9,000; Y has NOL carryforwards of $100. Z corporation is owned by individual C and its stock has a value of $18,000; Z has no NOL carryforwards. On July 22, 1988, X, Y, and Z consolidate into W corporation in a transaction that qualifies as a tax-free reorganization under section 368(a)(1)(A). The applicable long-term tax-exempt rate on such date is 10 percent. As a result of the consolidation, A receives 10 percent of W stock, B receives 30 percent, and C receives 60 percent.

The consolidation of X, Y, and Z results in an ownership change for old loss corporations X and Y. The Act applies a separate section 382 limitation to the utilization of the NOL carryforwards of each loss corporation that experiences an ownership change. Therefore, the annual limitation on X's NOL carryforwards is $300 and the annual limitation on Y's NOL carryforwards is $900.

For W's taxable year ending on December 31, 1989, W's taxable income before any reduction for its NOLs is $1,400. The amount of taxable income of W that may be offset by X and Y's pre-change losses (without regard to any unused section 382 limitation) is $400 (the $300 section 382 limitation for X's NOL carryforwards and all $100 of Y's NOL carryforwards because that amount is less than Y's $900 section 382 limitation). The unused portion of Y's section 382 limitation may not be used to augment X's section 382 limitation for 1989 or in any subsequent year.

Special rule for post-change year that includes the change date. In general, the section 382 limitation with respect to an ownership change that occurs during a taxable year does not apply to the utilization of losses against the portion of the loss corporation's taxable income, if any, allocable to the period before the change. For this purpose, except as provided in regulations, taxable income (not including built-in gains or losses, if there is a net unrealized built-in gain or loss) realized during the change year is allocated ratably to each day in the year. The regulations may provide that income realized before the change date from discrete sales of assets would be excluded from the ratable allocation and could be offset without limit by pre-change losses. Moreover, these regulations may provide a loss corporation with an option to determine the taxable income allocable to the period before the change by closing its books on the change date and thus forgoing the ratable allocation.

Value of loss corporation

The value of a loss corporation is generally the fair market value of the corporation's stock (including preferred stock described in section 1504(a)(4)) immediately before the ownership change (new sec. 382(e)(1)). If a redemption occurs in connection with an ownership change—either before or after the change—the value of the loss corporation is determined after taking the redemption into account (new sec. 382(e)(2)).[21] The Treasury Department is given regulatory authority to treat other corporate contractions in the same manner as redemptions for purposes of determining the loss corporation's value. The Treasury Department also is required to prescribe such regulations as are necessary to treat warrants, options, contracts to acquire stock, convertible debt, and similar interests as stock for purposes of determining the value of the loss corporation (new sec. 382(k)(6)(B)(i)).

In determining value, the price at which loss corporation stock changes hands in an arms-length transaction would be evidence, but not conclusive evidence, of the value of the stock. Assume, for example, that an acquiring corporation purchased 40 percent of loss corporation stock over a 12-month period. Six months following this 40 percent acquisition, the acquiring corporation purchased an additional 20 percent of loss corporation stock at a price that reflected a premium over the stock's proportionate amount of the value of all the loss corporation stock; the premium is paid because the 20-percent block carries with it effective control of the loss corporation. Based on these

[21] It was intended that the redemption provisions would apply to transactions that effectively accomplish similar economic results, without regard to formal differences in the structure used, or the order of events by which similar consequences are achieved. Thus, the fact that a transaction might not constitute a "redemption" for other tax purposes does not determine the treatment of the transaction for purposes of this provision. As one example, a "bootstrap" acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds to the old shareholders, could generally be subject to the provision. This may include cases in which debt used to pay the old shareholders remains an obligation of an acquisition corporation or an affiliate, where the source of funds for repayment of the obligation is the acquired corporation. *See* section 382(m)(4), relating to corporate contractions.

facts, it would be inappropriate to simply gross-up the amount paid for the 20-percent interest to determine the value of the corporation's stock. Under regulations, it is anticipated that the Treasury Department will permit the loss corporation to be valued based upon a formula that grosses up the purchase price of all of the acquired loss corporation stock if a control block of such stock is acquired within a 12-month period.

Example 24. All of the outstanding stock of L corporation is owned by individual A and has a value of $1,000. On June 15, 1988, A sells 51 percent of his stock in L to unrelated individual B. On January 1, 1989, L and A enter into a 15-year management contract and L redeems A's remaining stock interest in such corporation. The latter transactions were contemplated in connection with B's earlier acquisition of stock in 1988.

The acquisition of 51 percent of the stock of L on June 15, 1988, constituted an ownership change. The value of L for purposes of computing the section 382 limitation is the value of the stock of such corporation immediately before the ownership change. Although the value of such stock was $1,000 at that time, the value must be reduced by the value of A's stock that was subsequently redeemed in connection with the ownership change.

Long-term tax-exempt rate

The long-term tax-exempt rate is defined as the highest of the Federal long-term rates determined under section 1274(d), as adjusted to reflect differences between rates on long-term taxable and tax-exempt obligations, in effect for the month in which the change date occurs or the two prior months (new sec. 382(f)). The Treasury Department will publish the long-term tax-exempt rate by revenue ruling within 30 days after the date of enactment and monthly thereafter. The long-term tax-exempt rate will be computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years.

The use of a rate lower than the long-term Federal rate is necessary to ensure that the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation. Otherwise there would be a tax incentive to acquire loss corporations. If the loss corporation were to sell its assets and invest in long-term Treasury obligations, it could absorb its NOL carryforwards at a rate equal to the yield on long-term government obligations. Since the price paid by the buyer is larger than the value of the loss company's assets (because the value of NOL carryforwards are taken into account), applying the long-term Treasury rate to the purchase price would result in faster utilization of NOL carryforwards by the buying corporation. The long-term tax-exempt rate normally will fall between 66 (1 minus the maximum corporate tax rate of 34 percent) and 100 percent of the long-term Federal rate.

Example 25. Corporation L has $1 million of net operating loss carryforwards. L's taxable year is the calendar year, and on July 1, 1987, all of the stock of L is sold in a transaction constituting an ownership change of L. (Assume the transaction does not terminate L's taxable year.) On that date, the value of L's stock was $500,000 and the long-term tax-exempt rate was 10 percent. Finally, L incurred net operating loss during 1987 of $100,000, and L had no built-in gains or losses.

On these facts, the taxable income of L after July 1, 1987, that could be offset by L's losses incurred prior to July 1, 1987, would generally be limited. In particular, for all taxable years after 1987, the pre-change losses of L generally could be used to offset no more than $50,000 of L's taxable income each year. (For L's 1987 taxable year, the limit would be $25,000 (1/2 × the $50,000 section 382 limitation).) The pre-change losses of L would constitute the $1 million of NOL carryforwards plus one-half of the 1987 net operating loss, or a total of $1,050,000. If, in taxable year 1988, L had $30,000 of taxable income to be offset by L's losses, it could be fully offset by L's pre-change NOLs and the amount of L's 1989 taxable income that could be offset by pre-change losses would be limited to $95,000 ($50,000 annual limit plus $45,000 carryover).

If L had income of $100,000 in 1987, instead of a net operating loss, L's 1987 taxable income that could be offset by pre-change losses would generally be limited to $75,000 (1/2 × the $50,000 section 382 limitation plus 1/2 × $100,000 1987 income). (In appropriate circumstances, the Secretary could, by regulations, require allocation of income using a method other than daily proration. Such circumstances might include, for example, an instance in which substantial income-producing assets are contributed to capital after the change date.)

Continuity of business enterprise requirements

Following an ownership change, a loss corporation's NOL carryforwards (including any recognized built-in losses, described below) are subject to complete disallowance (except to the extent of any recognized built-in gains or section 338 gain, described below), unless the loss corporation's business enterprise is continued at all times during the two-year period following the ownership

change. If a loss corporation fails to satisfy the continuity of business enterprise requirements, no NOL carryforwards would be allowed to the new loss corporation for any post-change year. This continuity of business enterprise requirement is the same requirement that must be satisfied to qualify a transaction as a tax-free reorganization under section 368. (See Treasury regulation section 1.368-1(d).) Under these continuity of business enterprise requirements, a loss corporation (or a successor corporation) must either continue the old loss corporation's historic business or use a significant portion of the old loss corporation's assets in a business. Thus, the requirements may be satisfied even though the old loss corporation discontinues more than a minor portion of its historic business. Changes in the location of a loss corporation's business or the loss corporation's key employees, in contrast to the results under the business-continuation rule in the 1954 Code version of section 382(a), will not constitute a failure to satisfy the continuity of business enterprise requirements under the conference agreement.

Reduction in loss corporation's value for certain capital contributions

Any capital contribution (including a section 351 transfer) that is made to a loss corporation as part of a plan a principal purpose of which is to avoid any of the special limitations under section 382 shall not be taken into account for any purpose under section 382. For purposes of this rule, except as provided in regulations, a capital contribution made during the two-year period ending on the change date is irrebuttably presumed to be part of a plan to avoid the limitations. The application of this rule will result in a reduction of a loss corporation's value for purposes of determining the section 382 limitation. The term "capital contribution" is to be interpreted broadly to encompass any direct or indirect infusion of capital into a loss corporation (e.g., the merger of one corporation into a commonly owned loss corporation). Regulations generally will except (i) capital contributions received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built-in loss) where an ownership change occurs within two years of incorporation, (ii) capital contributions received before the first year from which there is an NOL or excess credit carryforward (or in which a net unrealized built-in loss arose), and (iii) capital contributions made to continue basic operations of the corporation's business (e.g., to meet the monthly payroll or fund other operating expenses of the loss corporation). The regulations also may take into account, under appropriate circumstances, the existence of substantial nonbusiness assets on the change date (as described below) and distributions made to shareholders subsequent to capital contributions, as offsets to such contributions.

Reduction in value for corporations having substantial nonbusiness assets

If at least one-third of the fair market value of a corporation's assets consists of nonbusiness assets, the value of the loss corporation, for purposes of determining the section 382 limitation, is reduced by the excess of the value of the nonbusiness assets over the portion of the corporation's indebtedness attributable to such assets. The term nonbusiness assets includes any asset held for investment, including cash and marketable stock or securities. Assets held as an integral part of the conduct of a trade or business (e.g., assets funding reserves of an insurance company or similar assets of a bank) would not be considered nonbusiness assets. In addition, stock or securities in a corporation that is at least 50 percent owned (voting power and value) by a loss corporation are not treated as nonbusiness assets. Instead, the parent loss corporation is deemed to own its ratable share of the subsidiary's assets. The portion of a corporation's indebtedness attributable to nonbusiness assets is determined on the basis of the ratio of the value of nonbusiness assets to the value of all the loss corporation's assets.

Regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits are not treated as having substantial nonbusiness assets.

Losses subject to limitation

The term "pre-change loss" includes (i) for the taxable year in which an ownership change occurs, the portion of the loss corporation's NOL that is allocable (determined on a daily pro rata basis, without regard to recognized built-in gains or losses, as described below) to the period in such year before the change date, (ii) NOL carryforwards that arose in a taxable year preceding the taxable year of the ownership change and (iii) certain recognized built-in losses and deductions (described below).

For any taxable year in which a corporation has income that, under section 172, may be offset by both a pre-change loss (i.e., an NOL subject to limitation) and an NOL that is not subject to limitation, taxable income is treated as having been first offset by the pre-change loss (new sec. 382(1)(2)(B)). This rule minimizes the NOLs that are subject to the special limitations. For purposes

of determining the amount of a prechange loss that may be carried to a taxable year (under section 172(b)), taxable income for a taxable year is treated as not greater than the section 382 limitation for such year reduced by the unused pre-change losses for prior taxable years. (New sec. 382(1)(2)(A)).

Built-in losses

If a loss corporation has a net unrealized built-in loss, the recognized built-in loss for any taxable year ending within the five-year period ending at the close of the fifth post-change year (the "recognition period") is treated as a pre-change loss (new sec. 382(h)(1)(B)).

Net unrealized built-in losses. The term "net unrealized built-in loss" is defined as the amount by which the fair market value of the loss corporation's assets immediately before the ownership change is less than the aggregate adjusted bases of a corporation's assets at that time. Under a de minimis exception, the special rule for built-in losses is not applied if the amount of a net unrealized built-in loss does not exceed 25 percent of the value of the corporation's assets immediately before the ownership change. For purposes of the de minimis exception, the value of a corporation's assets is determined by excluding any (1) cash, (2) cash items (as determined for purposes of section 368(a)(2)(F)(iv)), or (3) marketable securities that have a value that does not substantially differ from adjusted basis.

Example 26. L corporation owns two assets: asset X, with a basis of $150 and a value of $50 (a built-in loss asset), and asset Y, with a basis of zero and a value of $50 (a built-in gain asset, described below). L has a net unrealized built-in loss of $50 (the excess of the aggregate bases of $150 over the aggregate value of $100).

Recognized built-in losses. The term "recognized built-in loss" is defined as any loss that is recognized on the disposition of an asset during the recognition period, except to the extent that the new loss corporation establishes that (1) the asset was not held by the loss corporation immediately before the change date, or (2) the loss (or a portion of such loss) is greater than the excess of the adjusted basis of the asset on the change date over the asset's fair market value on that date. The recognized built-in loss for a taxable year cannot exceed the net unrealized built-in loss reduced by recognized built-in losses for prior taxable years ending in the recognition period.

The amount of any recognized built-in loss that exceeds the section 382 limitation for any post-change year must be carried forward (not carried back) under rules similar to the rules applicable to net operating loss carryforwards and will be subject to the special limitations in the same manner as a pre-change loss.

Accrued deductions. The Treasury Department is authorized to issue regulations under which amounts that accrue before the change date, but are allowable as a deduction on or after such date (e.g., deductions deferred by section 267 or section 465), will be treated as built-in losses. Depreciation deductions cannot be treated as accrued deductions or built-in losses;[22] however, the Secretary of the Treasury is required to conduct a study of whether built-in depreciation deductions should be subject to section 382, and report to the tax-writing committees of the Congress before January 1, 1989.

Built-in gains

If a loss corporation has a net unrealized built-in gain, the section 382 limitation for any taxable year ending within the five-year recognition period is increased by the recognized built-in gain for the taxable year (new sec. 382(h)(1)(A)).

Net unrealized built-in gains. The term "net unrealized built-in gain" is defined as the amount by which the value of a corporation's assets exceeds the aggregate bases of such assets immediately before the ownership change. Under the de minimis exception described above, the special rule for built-in gains is not applied if the amount of a net unrealized built-in gain does not exceed 25 percent of the value of a loss corporation's assets.

Recognized built-in gains. The term "recognized built-in gain" is defined as any gain recognized on the disposition of an asset during the recognition period, if the taxpayer establishes that the asset was held by the loss corporation immediately before the change date, to the extent the gain does not exceed the excess of the fair market value of such asset on the change date over the adjusted basis of the asset on that date. The recognized built-in gain for a taxable year cannot exceed the net unrealized built-in gain reduced by the recognized built-in gains for prior years in the recognition period.

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[22] Similarly, Section 382 does not provide relief for built-in income other than gain on disposition of an asset.

Bankruptcy proceedings

The special limitations do not apply after any ownership change of a loss corporation if (1) such corporation was under the jurisdiction of a bankruptcy court in a Title 11 or similar case immediately before the ownership change, and (2) the corporation's historic shareholders and creditors (determined immediately before the ownership change) own 50 percent of the value and voting power of the loss corporation's stock immediately after the ownership change (new sec. 382(1)(5)). The 50-percent test is satisfied if the corporation's shareholders and creditors own stock of a controlling corporation that is also in bankruptcy (new sec. 382(1)(5)(A)(ii)).

This special rule applies only if the stock-for-debt exchange, reorganization, or other transaction is ordered by the court or is pursuant to a plan approved by the court. For purposes of the 50-percent test, stock of a creditor that was converted from indebtedness is taken into account only if such indebtedness was held by the creditor for at least 18 months before the date the bankruptcy case was filed or arose in the ordinary course of the loss corporation's trade or business and is held by the person who has at all times held the beneficial interest in the claim. Indebtedness will be considered as having arisen in the ordinary course of the loss corporation's business only if the indebtedness was incurred by the loss corporation in connection with the normal, usual, or customary conduct of its business. It is not relevant for this purpose whether the debt was related to ordinary or capital expenditures of the loss corporation. In addition, stock of a shareholder is taken into account only to the extent such stock was received in exchange for stock that was held immediately before the ownership change.

If the exception for bankruptcy proceedings applies, several special rules are applicable. First, the pre-change losses and excess credits that may be carried to a post-change year are reduced by one-half of the amount of any cancellation of indebtedness income that would have been included in the loss corporation's income as a result of any stock-for-debt exchanges that occur as part of the Title 11 or similar proceeding under the principles of section 108(e)(10) (without applying section 108(e)(10)(B)). Thus, the NOL carryforwards would be reduced by 50 percent of the excess of the amount of the indebtedness canceled over the fair market value of the stock exchanged. Second, the loss corporation's pre-change NOL carryforwards are reduced by the interest on the indebtedness that was converted to stock in the bankruptcy proceeding and paid or accrued during the period beginning on the first day of the third taxable year preceding the taxable year in which the ownership change occurs and ending on the change date. Finally, after an ownership change that qualifies for the bankruptcy exception, a second ownership change during the following two-year period will result in the elimination of NOL carryforwards that arose before the first ownership change. The special bankruptcy provisions do not apply to stock-for-debt exchanges in informal workouts, but the Secretary of the Treasury is required to study informal bankruptcy workouts under sections 108 and 382, and report to the tax-writing committees of the Congress before January 1, 1988.

The Act provides an election, subject to such terms and conditions as the Secretary may prescribe, to forgo the exception for Title 11 or similar cases (new sec. 382(1)(5)(H)). If this election is made, the general rules described above will apply except that the value of the loss corporation will reflect any increase in value resulting from any surrender or cancellation of creditors' claims in the transaction (for purposes of applying new section 382(e)).

Thrift institutions

A modified version of the bankruptcy exception (described above) applies to certain ownership changes of a thrift institution involved in a G reorganization by virtue of section 368(a)(3)(D)(ii). This rule also applies to ownership changes resulting from an issuance of stock or equity structure shift that is an integral part of a transaction involving such a reorganization, provided that the transaction would not have resulted in limitations under prior law.[23] The bankruptcy exception is applied to qualified thrift reorganizations by requiring shareholders and creditors (including depositors) to retain a 20-percent (rather than 50-percent) interest. For this purpose, the fair market value of the outstanding stock of the new loss corporation includes the amount of deposits in such corporation

[23] For example, a supervisory conversion of a mutual thrift into a stock thrift qualifying under section 368(a)(3)(D)(ii), followed by an issuance of stock for cash, would come within this special rule. The issuance of stock would not be regarded as a second ownership change for purposes of the bankruptcy exception.

immediately after the change, as under prior law.[24] The general bankruptcy rules that eliminate from the NOL carryforwards both interest deductions on debt that was converted and income that would be recognized under the principles of section 108(e)(10) are not applicable to thrifts.

Transactions involving solvent thrifts, including a purchase of the stock of a thrift, or merger of a thrift into another corporation, will be subject to the general rules relating to ownership changes. The conversion of a solvent mutual savings and loan association into a stock savings and loan (or other transactions involving a savings and loan not entitled to special treatment), although not within the special rules applicable to troubled thrifts, will not necessarily constitute an ownership change. In such a conversion, the mutual thrift converts to stock form as a preliminary step to the issuance of stock to investors for purposes of raising capital. Under prior law IRS rulings, the entire transaction may qualify as a tax-free reorganization if certain conditions are met. For purposes of determining whether there has been an ownership change causing a limitation on the use of losses, the issuance of stock generally will be treated under the rules applicable to owner shifts. For example, the depositors holding liquidation accounts would generally be considered a group of less-than-5-percent shareholders, and if the stock were issued entirely to less-than-5-percent shareholders, or 5-percent shareholders acquired less than 50 percent, no ownership change would occur. Treasury regulations may be issued, on a prospective basis, that would treat public offerings generally in the same manner as equity structure shifts and treat the old shareholders and the persons acquiring stock in the offering as separate 5-percent shareholder groups. If such regulations are issued and apply this same approach to the conversion of a solvent mutual savings and loan association to stock form and the issuance of new stock, an ownership change could result, however, if the value of the stock issued in the public offering exceeds the equity of the depositors in the mutual represented by liquidation accounts. The application of any such regulations to thrift institutions (whether solvent or insolvent) would not be effective before January 1, 1989.

Carryforwards other than NOLs

The Act also amends section 383, relating to special limitations on unused business credits and research credits, excess foreign tax credits, and capital loss carryforwards. Under regulations to be prescribed by the Secretary, capital loss carryforwards will be limited to an amount determined on the basis of the tax liability that is attributable to so much of the taxable income as does not exceed the section 382 limitation for the taxable year, with the same ordering rules that apply under present law. Thus, any capital loss carryforward used in a post-change year will reduce the section 382 limitation that is applied to pre-change losses. In addition, the amount of any excess credit that may be used following an ownership change will be limited, under regulations, on the basis of the tax liability attributable to an amount of taxable income that does not exceed the applicable section 382 limitation, after any NOL carryforwards, capital loss carryforwards, or foreign tax credits are taken into account. The Act also expands the scope of section 383 to include passive activity losses and credits and minimum tax credits.

Anti-abuse rules

The Act does not alter the continuing application of section 269, relating to acquisitions made to evade or avoid taxes, as under prior law. Similarly, the SRLY and CRCO principles under the regulations governing the filing of consolidated returns will continue to apply. The *Libson Shops* doctrine will have no application to transactions subject to the provisions of the Act.

The Act provides that the Treasury Department shall prescribe regulations preventing the avoidance of the purposes of section 382 through the use of, among other thing, pass-through entities. For example, a special allocation of income to a loss partner should not be permitted to result in a greater utilization of losses than would occur if the principles of section 382 were applicable.

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[24] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in H. Con. Res. 395 as passed by the House and Senate in the 99th Congress. Also, under a literal interpretation of the statute, in order to meet the requirements of section 1504(a)(2), the shareholders and creditors of the old loss corporation must meet the 20-percent test in terms of value and voting power. New section 382(1)(5)(F)(ii)(III) provides a rule for determining the deemed value, but there is no similar rule for measuring voting power. It was not intended that the voting power requirement would apply in this situation to cause a failure of the 20-percent test solely because deposits do not carry adequate voting power. A technical correction may be needed so that the statute reflects this intent.

In the case of partnerships, for example, the regulations are expected to limit the tax benefits that may be derived from transactions in which allocations of partnership income are made to a loss partner or to a corporation that is a member of a consolidated group with NOL carryovers (a "loss corporation partner") under an arrangement that contemplates the diversion of any more than an insignificant portion of the economic benefit corresponding to such allocation (or any portion of the economic benefit of the loss corporation partner's NOL) to a higher tax bracket partner.

This grant of authority contemplates any rules that the Treasury Department considers appropriate to achieve this objective. For example, regulations may provide, as a general rule, that the limitations of section 382 (and section 383) should be made applicable to restrict a loss corporation partner's use of losses against its distributive share of each item of partnership income and that any portion of the distributive share of partnership income so allocated which may not be offset by the loss corporation's NOLs should be taxed at the highest marginal tax rate. Such regulations could also provide that the allocation of income to the loss corporation may, in the discretion of the Secretary, be reallocated to the extent that other partners in the partnership have not been reasonably compensated for their services to the partnership. If the Treasury Department uses such a format to restrict the utilization of NOLs, it may be appropriate to exempt from these rules any partnership with respect to which, throughout the term of the partnership, (i) every allocation to every partner would be a qualified allocation as described in section 168(j)(9)(B) if it were made to a tax-exempt entity, with appropriate exceptions (e.g., section 704(c) allocations) and (ii) distributions are made to one partner only if there is a simultaneous pro rata distribution to all partners at the same time. Special rules would, of course, have to be provided to apply section 382 (and section 383) in this context.

No inference was intended regarding whether allocations made to loss corporations by partnerships that involve transfers of the economic benefit of a loss partner's loss to another partner have substantial economic effect. As described in the report of the Committee on Finance, there are circumstances in which it appears to be questionable whether the economic benefit that corresponds to a special allocation to the NOL partner is fully received by such partner; however, some taxpayers nevertheless take the position that such allocations have substantial economic effect under section 704(b). The Treasury Department is expected to review this situation.

The regulations issued under this grant of authority with respect to partnerships should be effective for transactions after the date of enactment. Any regulations addressing other situations, under the Treasury Department's general authority to limit the ability of other parties to obtain any portion of the benefit of a loss corporation's losses, may be prospective within the general discretion of the Secretary.

1976 Act Amendments

The Act generally repeals the amendments to section 382 and 383 made by the Tax Reform Act of 1976, effective retroactively as of January 1, 1986. Thus, the law that was in effect as of December 31, 1985, applies to transactions that are not subject to the new provisions because of the effective dates of the conference agreement. The Act, by repealing the 1976 Act amendments, also retroactively repeals section 108(e)(10)(C), as included by the Tax Reform Act of 1984.

Effective Dates

The provisions of the Act generally apply to ownership changes that occur on or after January 1, 1987. In the case of equity structure shifts (notwithstanding the fact that the transaction falls within the definition of an owner shift), the new rules apply to reorganizations pursuant to plans adopted on or after January 1, 1987. In the case of an ownership change occurring immediately after an owner shift (other than an equity structure shift) completed on or after January 1, 1987, new section 382 shall apply. In the case of an equity structure shift (including equity structure shifts that are also owner shifts), Congress intended that new section 382 shall apply to any post-1986 ownership change occurring immediately after the completion of any reorganization pursuant to a plan adopted on or after January 1, 1987. Congress also intended that new section 382 shall apply to any post-1986 ownership change occurring immediately after the completion of a reorganization pursuant to a plan adopted before January 1, 1987, unless the shift in ownership caused by such reorganization, when considered together only with any other shifts in ownership that may have occurred on or after May 6, 1986, and before December 31, 1986, would have caused an ownership change.[25]

[25] A reorganization pursuant to a 1986 plan is thus treated under the Act as if the reorganization (and any ownership change resulting from the plan) occurred in 1986 when the plan was adopted. Other shifts in ownership in 1987 before completion of a 1986 plan are not protected.

For purposes of the effective date rules, if there is an ownership change with respect to a subsidiary corporation as the result of the acquisition of the parent corporation, the subsidiary's treatment is governed by the nature of the parent-level transaction. For example, if all the stock of a parent corporation is acquired in a tax-free reorganization pursuant to a plan adopted before January 1, 1987, then the resulting indirect ownership change with respect to a subsidiary loss corporation will be treated as having occurred by reason of a reorganization pursuant to a plan adopted before January 1, 1987.

A reorganization plan will be considered adopted on the date that the boards of directors of all parties to the reorganization adopt the plans or recommend adoption to the shareholders, or on the date the shareholders approve, whichever is earlier. The parties' boards of directors may approve a plan of reorganization based on principles, and negotiations to date, and delegate to corporate officials the power to refine and execute a binding reorganization agreement, including a binding agreement subject to regulatory approval. Any subsequent board approval or ratification taken at the time of consummating the transaction as a formality (i.e., that is not required, because the reorganization agreement is already legally binding under prior board approval) may occur without affecting the application of the effective date rule for reorganizations. In the case of a reorganization described in section 368(a)(1)(G) or an exchange of debt for stock in a Title 11 or similar case, the amendments do not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986.

The earliest testing period under the Act begins on May 6, 1986 (the date of Senate Finance Committee action).[26] If an ownership change occurs after May 5, 1986, but before January 1, 1987, and section 382 and 383 (as amended by the Act) do not apply, then the earliest testing date will not begin before the first day following the date of such ownership change. For example, assume 60 percent of a loss corporation's stock (wholly owned by X) is purchased by B on May 29, 1986, and section 382 under the 1954 Code does not apply (because, for example, the loss corporation's business is continued and section 269 is not implicated). Assume further that X's remaining 40 percent stock interest is acquired by B on February 1, 1987. Under the Act, no ownership change occurs after the second purchase because the testing period begins on May 30, 1986, the day immediately after the ownership change; thus, an ownership change would not result from the second purchase. Conversely, if 40 percent of a loss corporation's stock (wholly owned by X) is purchased by D on July 1, 1986, and an additional 15 percent is purchased by P on January 15, 1987, then an ownership change would result from the second purchase, and the amendments would apply to limit the use of the loss corporation's NOL carryforwards.

Moreover, if an ownership change that occurs after December 31, 1986 is not affected by the amendments to section 382 (because, for example, in the foregoing example the initial 40 percent stock purchase occurred on May 5, 1986, prior to the commencement of the testing period), the 1954 Code version of section 382 will remain applicable to the transaction. The 1954 Code version of section 382 is generally intended to have continuing application to any increase in percentage points to which the amendments made by the Act do not apply by application of any transitional rule, including the rules prescribing measurement of the testing period by reference only to transactions after May 5, 1986, and the rules grandfathering or disregarding ownership changes following or resulting from certain transactions.[27]

For purposes of determining whether shifts in ownership have occurred on or after May 6, 1986 and before December 31, 1986, the rule of section 382(1)(3)(A)(iv) in the case of options, and the similar rule in the case of any contingent purchase, warrant, convertible debt, stock subject to a risk of forfeiture, contract to acquire stock, or similar interests, shall apply. For example, in the case of such interests issued on or after May 6, 1986,[28] the underlying stock could generally be treated as acquired at the time the interest was issued. However, for this transition period, it is expected that the Treasury Department may provide for a different treatment in the case of an acquisition of an option or other interest that is not in fact exercised, as appropriate where the effect of treating the underlying stock as if it were acquired would be to cause an ownership change that would be grandfathered under the transition rules and start a new testing period.

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[26] The Congress intended the May 6, 1986 date to apply for purposes of determining whether an ownership change occurred after May 5, 1986 but before January 1, 1987.

[27] A technical correction may be needed so that the statute reflects this intent.

[28] No inference is intended as to how pre-May 6, 1986 options or other interests would be treated.

Contingent interests arising prior to January 1, 1987, for example, contingent options created in business transactions occurring prior to that date, are not treated as ownership changes merely by operation of the January 1, 1987, effective date. No inference is intended regarding the treatment of such contingent interests under the Act, other than to clarify that they are not treated as ownership changes merely by operation of the January 1, 1987 effective date.[29]

Special transitional rules are provided under which prior law continues to apply to certain ownership changes after January 1, 1987.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $9 million in 1987, $29 million in 1988, $39 million in 1989, $38 million in 1990, and $29 million in 1991.

RECOGNITION OF GAIN OR LOSS ON LIQUIDATING SALES AND DISTRIBUTIONS OF PROPERTY (*GENERAL UTILITIES*) (SECS. 631, 632, AND 633 OF THE ACT AND SECS. 336, 337, AND 1374 OF THE CODE)3[30]

Prior Law

Overview

As a general rule, under prior law (as under present law) corporate earnings from sales of appreciated property were taxed twice, first to the corporation when the sale occurred, and again to the shareholders when the net proceeds were distributed as dividends. At the corporate level, the income was taxed at ordinary rates if it resulted from the sale of inventory or other ordinary income assets, or at capital gains rates if it resulted from the sale of a capital asset held for more than six months. With certain exceptions, shareholders were taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits.

An important exception to this two-level taxation of corporate earnings was the so-called *General Utilities* rule.[31] The *General Utilities* rule permitted nonrecognition of gain by corporations on certain distributions of appreciated property[32] to their shareholders and on certain liquidating sales of property. Thus, its effect was to allow appreciation in property accruing during the period it was held by a corporation to escape tax at the corporate level. At the same time, the transferee (the shareholder or third-party purchaser) obtained a stepped-up, fair market value basis under other provisions of the Code, with associated additional depreciation, depletion, or amortization deductions. Accordingly, the "price" of a step up in the basis of property subject to the *General Utilities* rule was typically a single capital gains tax paid by the shareholder on receipt of a liquidating distribution from the corporation.

Although the *General Utilities* case involved a dividend distribution of appreciated property by an ongoing business, the term "*General Utilities* rule" was often used in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidating as well as nonliquidating distributions to shareholders and to liquidating sales. The rule was reflected in Code sections 311, 336, and 337 of prior law.[33] Section 311 governed the treatment of nonliquidating distributions of property (dividends and redemptions), while section 336 governed the treatment of liquidating

[29] *See* Floor statements by Mr. Rostenkowski, 132 *Cong. Rec*. H8363 (September 25, 1986) and 132 Cong. Rec. E 3390 (October 2, 1986); and Senators Dole and Packwood, 132 Cong. Rec. S 13958 (September 27, 1986).

[30] For legislative background of the provision, *see*: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 331; H.Rep. 99-426, pp. 274–291; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 198–207 (Conference Report).

[31] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

[32] Taxable gain may result on disposition of property even if the property's economic value remains constant (or decreases) over the taxpayer's holding period, due to tax depreciation and other downward adjustments to basis. The term "appreciated property" as used herein refers to property whose fair market value or sales price exceeds its adjusted (and not necessarily its original) basis in the hands of the transferor corporation.

[33] Unless otherwise indicated, all section references in this section ("Prior Law") are to the Internal Revenue Code of 1954, as in effect immediately prior to the effective date of the amendments made by the Act.

distributions in kind. Section 337 provided nonrecognition treatment for certain sales of property pursuant to a plan of complete liquidation.

Numerous limitations on the *General Utilities* rule, both statutory and judicial, developed over the years following its codification. Some directly limited the statutory provisions embodying the rule, while others, including the collapsible corporation provisions, the recapture provisions, and the tax benefit doctrine, did so indirectly.

Case Law and Statutory Background

Genesis of the General Utilities *rule*

The precise meaning of *General Utilities* was a matter of considerable debate in the years following the 1935 decision. The essential facts were as follows. General Utilities had purchased 50 percent of the stock of Islands Edison Co. in 1927 for $2,000. In 1928, a prospective buyer offered to buy all of General Utilities' shares in Islands Edison, which apparently had a fair market value at that time of more than $1 million. Seeking to avoid the large corporate-level tax that would be imposed if it sold the stock itself, General Utilities offered to distribute the Islands Edison stock to its shareholders with the understanding that they would then sell the stock to the buyer. The company's officers and the buyer negotiated the terms of the sale but did not sign a contract. The shareholders of General Utilities had no binding commitment upon receipt of the Islands Edison shares to sell them to the buyer on these terms.

General Utilities declared a dividend in an amount equal to the value of the Islands Edison stock, payable in shares of that stock. The corporation distributed the Islands Edison shares and, four days later, the shareholders sold the shares to the buyer on the terms previously negotiated by the company's officers.

The Internal Revenue Service took the position that the distribution of the Islands Edison shares was a taxable transaction to General Utilities. Before the Supreme Court, the Commissioner argued that the company had created an indebtedness to its shareholders in declaring a dividend, and that the discharge of this indebtedness using appreciated property produced taxable income to the company under the holding in *Kirby Lumber Co. v. United States*.[34] Alternatively, he argued, the sale of the Islands Edison stock was in reality made by General Utilities rather than by its shareholders following distribution of the stock. Finally, the Commissioner contended that a distribution of appreciated property by a corporation in and of itself constitutes a realization event. All dividends are distributed in satisfaction of the corporation's general obligation to pay out earnings to shareholders, he argued, and the satisfaction of that obligation with appreciated property causes a realization of the gain.

The Supreme Court held that the distribution did not give rise to taxable income under a discharge of indebtedness rationale. The Court did not directly address the Commissioner's third argument, that the company realized income simply by distributing appreciated property as a dividend. There is disagreement over whether the Court rejected this argument on substantive grounds or merely on the ground it was not timely made. Despite the ambiguity of the Supreme Court's decision, however, subsequent cases interpreted the decision as rejecting the Commissioner's third argument and as holding that no gain is realized on corporate distributions of appreciated property to its shareholders.

Five years after the decision in *General Utilities*, in a case in which the corporation played a substantial role in the sale of distributed property by its shareholders, the Commissioner successfully advanced the imputed sale argument the Court had rejected earlier on procedural grounds. In *Commissioner v. Court Holding Co.*,[35] the Court upheld the Commissioner's determination that, in substance, the corporation rather than the shareholders had executed the sale and, accordingly, was required to recognize gain.

In *United States v. Cumberland Public Service Co.*,[36] the Supreme Court reached a contrary result where the facts showed the shareholders had in fact negotiated a sale on their own behalf. The Court stated that Congress had imposed no tax on liquidating distributions in kind or on dissolution, and that a corporation could liquidate without subjecting itself to corporate gains tax notwithstanding the primary motive is to avoid the corporate tax.[37]

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[34] 284 U.S. 1 (1931).
[35] 324 U.S. 331 (1945).
[36] 338 U.S. 451 (1950).
[37] Id. at 454–455.

In its 1954 revision of the Internal Revenue Code, Congress reviewed *General Utilities* and its progeny and decided to address the corporate-level consequences of distributions statutorily. It essentially codified the result in *General Utilities* by enacting section 311(a) of prior law, which provided that a corporation recognized no gain or loss on a nonliquidating distribution of property with respect to its stock. Congress also enacted section 336, which in its original form provided for nonrecognition of gain or loss to a corporation on distributions of property in partial or complete liquidation. Although distributions in partial liquidations were eventually removed from the jurisdiction of section 336, in certain limited circumstances a distribution in partial liquidation could, prior to the Act, still qualify for nonrecognition at the corporate level."[38]

Finally, Congress in the 1954 Act provided that a corporation did not recognize gain or loss on a sale of property if it adopted a plan of complete liquidation and distributed all of its assets to its shareholders within twelve months of the date of adoption of the plan (sec. 337). Thus, the distinction drawn in *Court Holding Co.* and *Cumberland Public Service Co.*, between a sale of assets followed by liquidating distribution of the proceeds and a liquidating distribution in kind followed by a shareholder sale, was in large part eliminated. Regulations subsequently issued under section 311 acknowledged that a distribution in redemption of stock constituted a "distribution with respect to . . . stock" within the meaning of the statute.[39] The 1954 Code in its original form, therefore, generally exempted all forms of nonliquidating as well as liquidating distributions to shareholders from the corporate-level tax.

Nonliquidating distributions: section 311

Congress subsequently enacted a number of statutory exceptions to the *General Utilities* rule. Under prior law (as under present law), the presumption under *General Utilities* was reversed for nonliquidating distributions: the general rule was that a corporation recognized gain (but not loss) on a distribution of property as a dividend or in redemption of stock.[40] The distributing corporation is treated as if it sold the property for its fair market value on the date of the distribution. A number of exceptions to the general rule were provided. First, no gain was generally recognized to the distributing corporation with respect to distributions in partial liquidation made with respect to "qualified stock." Qualified stock was defined as stock held by noncorporate shareholders who at all times during the five-year period prior to the distribution (or the period the corporation had been in existence, if shorter) owned 10 percent or more in value of the distributing corporation's outstanding stock.[41]

Second, an exception from the general gain recognition rule was provided for a distribution with respect to qualified stock that constituted a "qualified dividend." A "qualified dividend" for this purpose was a dividend of property (other than inventory or receivables) used in the active conduct of certain "qualified businesses."[42] A "qualified business" was any trade or business that had been actively conducted for the five-year period ending on the date of the distribution and was not acquired in a transaction in which gain or loss was recognized in whole or in part during such period.[43] Thus, nonrecognition under this exception did not apply to distributions from holding companies or consisting of ordinary income property, and was limited to distributions to certain long-term, 10-percent shareholders other than corporations.

Third, an exception was provided for distributions with respect to qualified stock of stock or obligations in a subsidiary if substantially all of the assets of the subsidiary consisted of the assets of one or more qualified businesses, no substantial part of the subsidiary's nonbusiness assets were acquired in a section 351 transaction or as a capital contribution from the distributing corporation within the five-year period ending on the date of the distribution, and more than 50 percent in value of the stock of the subsidiary was distributed with respect to qualified stock.[44] Finally, exceptions were provided for

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[38] This exception for partial liquidations is discussed below under the heading "*Nonliquidating distributions*."

[39] Treas. Reg. sec. 1.311-1(a).

[40] The statute (sec. 311(d)(1)(A)) by its terms applied only to "distribution[s] to which subpart A [of subchapter C, part I] applies. . . ."

[41] *See* secs. 311(d)(2)(A) and 302(b)(4) and (e). The Treasury Department was granted regulatory authority to prevent taxpayers not eligible for this special partial liquidation treatment from obtaining these benefits through the use of section 355, 351, 337, or other provisions of the Code or the regulations (sec. 346(b)).

[42] Sec. 311(e)(3).

[43] Sec. 311(e)(2)(B)(i).

[44] Sec. 311(d)(2)(B).

redemptions to pay death taxes, certain distributions to private foundations, and distributions by certain regulated investment companies in redemption of stock upon the demand of a shareholder.[45]

Section 311 also provided under separate rules that a corporation recognized gain on the distribution of encumbered property to the extent the liabilities assumed or to which the property was subject exceeded the distributing corporation's adjusted basis;[46] on the distribution of LIFO inventory, to the extent the basis of the inventory determined under a FIFO method exceeded its LIFO value;[47] and on the distribution of an installment obligation, to the extent of the excess of the face value of the obligation over the distributing corporation's adjusted basis in the obligation.[48]

Liquidating distributions and sales: sections 336 and 337

The rules regarding nonrecognition of gain on distributions in liquidation of a corporation were less restrictive than those applicable to nonliquidating distributions under prior law. Section 336 of prior law generally provided for nonrecognition of gain or loss by a corporation on the distribution of property in complete liquidation of the corporation. Gain was recognized, however, on a distribution of an installment obligation, unless the obligation was acquired in a liquidating sale that would have been tax-free under section 337, or the distribution was by a controlled subsidiary in a section 332 liquidation where the parent took a carryover basis under section 334(b)(1).[49] Section 336 also required recognition of the LIFO recapture amount in liquidating distributions.

Section 337 of prior law provided that if a corporation adopted a plan of complete liquidation and within twelve months distributed all of its assets in complete liquidation, gain or loss on any sales by the corporation during that period generally was not recognized. Section 337 did not apply, and recognition was required, on sales of inventory (other than inventory sold in bulk), stock in trade, and property held primarily for sale to customers in the ordinary course of business. If the corporation accounted for inventory on a LIFO basis, section 337 required that the LIFO recapture amount be included in income.

Distributions by S corporations

Under both prior and present law, a closely-held business operating in corporate form may elect to have business gains and losses taxed directly to or deducted directly by its individual shareholders. This election is available under subchapter S of the Code (secs. 1361–1379). The principal advantage of a subchapter S election to the owners of a business is the ability to retain the advantages of operating in corporate form while avoiding taxation of corporate earnings at both the corporate and shareholder levels.

Prior to 1983, shareholders of corporations making a subchapter S election were taxed on actual cash dividend distributions of current earnings and profits of the corporation, and on undistributed taxable income as a deemed dividend. Accordingly, all of the taxable income of a corporation taxable under subchapter S passed through to its shareholders as dividends. A shareholder increased his basis in his stock by the amount of his pro rata share of undistributed taxable income.

The Subchapter S Revision Act of 1982 substantially modified these rules. The dividends-earnings and profits system was abandoned in favor of a pass-through approach based more closely on the system under which partnership income is taxed. Under these new rules, gain must be recognized by an S corporation (which gain is passed through to its shareholders) on a nonliquidating distribution of appreciated property as if it had sold the property for its fair market value (sec. 1363(d)). The purpose of this rule is to assure that the appreciation does not escape tax entirely. A shareholder in an S corporation generally does not recognize gain on receipt of property from the corporation,

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[45] Sec. 311(d)(2)(C), (D), (E).

[46] In the case of a distribution of property that was subject to a liability that was not assumed by the shareholder, the gain recognized was limited to the excess of the property's fair market value over its adjusted basis (sec. 311(c)). If the liability was nonrecourse, however, fair market value was treated as being not less than the amount of the liability (sec. 7701(g)).

[47] Sec. 311(b). Under the last-in, first-out or "LIFO" method of accounting, goods purchased or produced most recently are deemed to be the first goods sold. "FIFO" (first-in, first-out) accounting assumes that the first goods purchased or produced are the first goods sold. The LIFO recapture and installment obligation rules were applied before the recognition rules of section 311(d)(1).

[48] Sec. 453B. Installment obligations received by a corporation in a sale or exchange qualifying for nonrecognition under section 337 could be distributed to shareholders without recognition at the corporate level. Sec. 453B(d)(2).

[49] Sec. 453B(d).

but simply reduces his basis in his stock by the fair market value of the property, taking a basis in the property equal to that value. The shareholder can then sell the property without recognizing any gain. Thus, unless the distribution triggered gain at the corporate level, no current tax would be paid on the appreciation in the distributed property.

Under prior law, liquidating distributions by an S corporation were taxed in the same manner as liquidating distributions of C corporations. Thus, no gain was recognized by the corporation (secs. 1363(e) and 336). Although the *General Utilities* rule in this context was not responsible for the imposition of only a single, shareholder level tax on appreciation in corporate property,[50] it could allow a portion of the gain that would otherwise be ordinary to receive capital gains treatment under prior law.

Statutory Law and Judicial Doctrines Affecting Application of* General Utilities *Rule

Recapture rules

The nonrecognition provisions of sections 311, 336, and 337 were subject to several additional limitations beyond those expressly set forth in those sections. These limitations included the statutory "recapture" rules for depreciation deductions, investment tax credits, and certain other items that might have produced a tax benefit for the transferor-taxpayer in prior years.[51]

The depreciation recapture rules (sec. 1245) required inclusion, as ordinary income, of any gain attributable to depreciation deductions previously claimed by the taxpayer with respect to "section 1245 property"—essentially, depreciable personal property—disposed of during the year, to the extent the depreciation claimed exceeded the property's actual decline in value.[52]

A more limited depreciation recapture rule applied to real estate. Under section 1250, gain on disposition of residential real property held for more than one year was recaptured as ordinary income to the extent prior depreciation deductions exceeded depreciation computed on the straight-line method. Gain on disposition of nonresidential real property held for more than one year, however, was generally subject to recapture of all depreciation unless a straight-line method had been elected, in which case there was no recapture.[53]

A number of other statutory recapture provisions could apply to a liquidating or nonliquidating distribution of property, including section 617(d) (providing for recapture of post-1965 mining exploration expenditures), section 1252 (soil and water conservation and land-clearing expenditures), and section 1254 (post-1975 intangible drilling and development costs).

Collapsible corporation rules

Under prior law (as under present law), section 341 modified the tax treatment of transactions involving stock in or property held by "collapsible" corporations. In general, a collapsible corporation was one the purpose of which was to convert ordinary income into capital gain through the sale of stock by its shareholders, or through liquidation of the corporation, before substantial income had been realized.

Under section 341, if a shareholder disposed of stock in a collapsible corporation in a transaction that would ordinarily produce long-term capital gain, the gain was treated as ordinary income. Likewise, any gain realized by a shareholder on a liquidating distribution of property from a collapsible corporation was ordinary income. Finally, prior law section 337 was inapplicable in the case of a collapsible corporation. Thus, liquidating sales of appreciated inventory or other property held by the corporation for sale to customers generated ordinary income that was fully recognized at the corporate level.[54]

[50] A shareholder would under the subchapter S rules be entitled to a basis increase equal to the amount of gain recognized by the corporation.

[51] These rules applied not just to corporate distributions but to sales and other dispositions of property, other than in tax-free reorganizations.

[52] In the case of sales or exchanges of property in taxable transactions, the effect of this provision was to convert a portion of what would otherwise be capital gain into ordinary income. In the case of nonrecognition transactions, the effect was to require recognition of gain that would otherwise have gone unrecognized.

[53] Sec. 1245(a)(5). *See also* sec. 291(a), subjecting a portion of the straight-line depreciation on real estate to recapture in the case of corporations.

[54] It was possible for gain on sales of capital or section 1231 assets in a section 337 liquidation of a collapsible corporation to be eligible for taxation at capital gains rates. A sale in liquidation could produce corporate level income that eliminated the collapsible status of the corporation, so that the shareholders were eligible for capital gains treatment on any gain realized on relinquishment of their shares in the liquidation.

Certain stock purchases treated as asset purchases

Under both prior and present law, section 338 permits a corporation that purchases a controlling stock interest in another corporation (the "target" corporation) within a twelve-month period to elect to treat the transaction as a purchase of the assets of that corporation for tax purposes. If the election is made, the target is treated as if it had sold all of its assets pursuant to a plan of complete liquidation on the date the purchaser obtained a controlling interest in the target (the "acquisition date"), for an amount essentially equal to the purchase price of the stock plus its liabilities. Under prior law, this deemed sale was regarded as occurring under 337. Accordingly, no gain was recognized on the deemed sale other than gain attributable to section 1245 or other provisions that override section 337. The target was then treated as a newly organized corporation which purchased all of the "old" target's assets for a price essentially equal to the purchase price of the stock plus the old target's liabilities on the beginning of the day after the qualified stock purchase. Thus, the new target corporation was able to obtain a stepped-up basis in its assets equal to their fair market value.

Prior to the enactment of section 338, similar results could be achieved under section 332 and former section 334(b)(2) by liquidating the acquired corporation into its parent within a specified period of time. One abuse Congress sought to prevent in enacting section 338 was selective tax treatment of corporate acquisitions. Taxpayers were able to take a stepped-up basis in some assets held by a target corporation or its affiliates while avoiding recapture tax and other unfavorable tax consequences with respect to other assets.[55] Section 338 contains elaborate "consistency" rules designed to prevent selectivity with respect to acquisitions of stock and assets of a target corporation (and its affiliates) by an acquiring corporation (and its affiliates). All such purchases by the acquiring group must be treated consistently as either asset purchases or stock purchases if they occur within the period beginning one year before and ending one year after the twelve-month acquisition period.[56]

Section 338 of prior (and present) law contained an alternative election under which, in certain circumstances, a corporate purchaser and a seller of an 80-percent-controlled subsidiary could elect to treat the sale of the subsidiary stock as if it had been a sale of the underlying assets. Among the requirements for the filing of an election under section 338(h)(10) were that the selling corporation and its target subsidiary must be members of an affiliated group filing a consolidated return for the taxable year that included the acquisition date. If an election was made, the underlying assets of the corporation that was sold received a stepped-up, fair market value basis; the selling consolidated group recognized the gain or loss attributable to the assets; and there was no separate tax on the seller's gain attributable to the stock. This provision offered taxpayers relief from a potential multiple taxation at the corporate level of the same economic gain, which could result when a transfer of appreciated corporate stock was taxed without providing a corresponding step-up in basis of the assets of the corporation.

Judicially created doctrines

Under prior law, the courts applied nonstatutory doctrines from other areas of the tax law to in-kind distributions to shareholders. These doctrines also apply under present law. For example, it was held that, where the cost of property distributed in a liquidation or sold pursuant to a section 337 plan of liquidation had previously been deducted by the corporation, the tax benefit doctrine overrode the statutory rules to cause recognition of income.[57] The application of the tax benefit doctrine turns on whether there is a "fundamental inconsistency" between the prior deduction and some subsequent event.[58]

The courts also applied the assignment of income doctrine to require a corporation to recognize income on liquidating and nonliquidating distributions of its property.[59]

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[55] Prior to TEFRA, a step-up could be achieved through a partial liquidation of the target as well as a complete liquidation under sections 332 and 334(b)(2).

[56] Exceptions are provided for assets acquired in the ordinary course of business, acquisitions in which the basis of property is carried over, and other asset acquisitions as provided in regulations.

[57] *See, e.g.*, *Bliss Dairy v. United States*, 460 U.S. 370 (1983) and *Tennessee Carolina Transportation, Inc. v. Commissioner*, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978) (liquidating distribution of previously expensed items); *Estate of Munter v. Commissioner*, 63 T.C. 663 (1975) (sale of previously deducted items pursuant to plan of liquidation).

[58] *Bliss Dairy*, *supra*.

[59] *E.g.*, *Commissioner v. First State Bank*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948) (a decision rendered prior to the enactment of sec. 311); *Siegel v. United States*, 464 U.S. 891 (1972), *cert. dism'd*, 410 U.S. 918 (1973).

Reasons for Change

In General

Congress believed that the *General Utilities* rule, even in its more limited form, produced many incongruities and inequities in the tax system. First, the rule could create significant distortions in business behavior. Economically, a liquidating distribution is indistinguishable from a nonliquidating distribution; yet the Code provided a substantial preference for the former. A corporation acquiring the assets of a liquidating corporation was able to obtain a basis in assets equal to their fair market value, although the transferor recognized no gain (other than possibly recapture amounts) on the sale. The tax benefits made the assets potentially more valuable in the hands of a transferee than in the hands of the current owner. This might induce corporations with substantial appreciated assets to liquidate and transfer their assets to other corporations for tax reasons, when economic considerations might indicate a different course of action. Accordingly, Congress reasoned, the *General Utilities* rule could be at least partly responsible for the dramatic increase in corporate mergers and acquisitions in recent years. Congress believed that the Code should not artificially encourage corporate liquidations and acquisitions, and that repeal of the *General Utilities* rule was a major step towards that goal.

Second, the *General Utilities* rule tended to undermine the corporate income tax. Under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property, thus assuring that a tax will eventually be collected on the appreciation. Where the *General Utilities* rule applied, assets generally were permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without the imposition of a corporate-level tax.[60] Thus, the effect of the rule was to grant a permanent exemption from the corporate income tax.

Anti-tax Avoidance Provisions

In repealing the *General Utilities* rule, which provided for nonrecognition of losses as well as gains on distributions, Congress was concerned that taxpayers might utilize various means (including other provisions of the Code or the Treasury regulations) to circumvent repeal of the rule or, alternatively, might exploit the provision to realize losses in inappropriate situations or inflate the amount of the losses actually sustained. For example, under the general rule permitting loss recognition on liquidating distributions, taxpayers might be able to create artificial losses at the corporate level or to duplicate shareholder losses in corporate solution through contributions of property having previously accrued ("built-in") losses. In an effort to prevent these potential abuses, Congress included in the Act regulatory authority to prevent circumvention of the purposes of the amendments through use of any provision of law or regulations. In addition, it included specific statutory provisions designed to prevent avoidance of tax on corporate-level gains through conversions to subchapter S corporation status and unwarranted recognition of losses at the corporate level.

Conforming Changes to Provisions Relating to Nonliquidating Distributions

The tax treatment of corporations with respect to nonliquidating distributions of appreciated property historically has been the same as liquidating distributions. In recent years, however, nonliquidating distributions have been subjected to stricter rules than liquidating distributions, and corporations have generally been required to recognize gain as a result of nonliquidating distributions of appreciated property. Consistent with this relationship, the Act generally conforms the treatment of nonliquidating distributions with liquidating distributions.

Relief from Repeal of the **General Utilities** *Rule*

Several exceptions to the recognition requirement are provided in the Act. The first relates to distributions of the stock and securities of a controlled subsidiary which under prior law (as under the Act) the distribute shareholder may receive tax-free pursuant to section 355. Congress felt that the same policy rationale that justifies nonrecognition by the shareholder on receipt of the stock—namely, that the transfer merely effects a readjustment of the shareholder's continuing interest in the

[60] The price of this basis step up was, at most, a single, shareholder-level capital gains tax (and perhaps recapture, tax benefit, and other similar amounts). In some cases, moreover, payment of the capital gains tax was deferred because the shareholder's gain was reported under the installment method.

corporation in modified form and subject to certain statutory and other constraints—also justifies nonrecognition of gain (or loss) to the distributing corporation in this situation. Similarly, certain distributions pursuant to a plan of reorganization also are not subject to recognition.[61]

Another exception relates to certain section 332 liquidations in which an 80-percent corporate shareholder receives property with a carryover basis. Congress believed that this exception was justified on the ground that the property (together with the other attributes of the liquidated subsidiary) is retained within the economic unit of the affiliated group. Because such an intercorporate transfer within the group is a nonrecognition event, carryover basis follows. As a result of the carryover basis, the corporate-level tax will be paid if the distributed property is disposed of by the recipient corporation to a person outside of the group. Where gain recognition with respect to the distributed property would not be preserved (e.g., certain transfers to a tax-exempt or foreign corporate parent), the exception for liquidating distributions to an 80-percent corporate shareholder does not apply.[62]

Election to Treat Sales or Distributions of Certain Subsidiary Stock as Asset Transfers

Congress believed it was appropriate to conform the treatment of liquidating and nonliquidating sales or distributions and to require recognition when appreciated property, including stock of a subsidiary, is transferred to a corporate or individual recipient outside the economic unit of the selling or distributing affiliated group. Thus, the Act provides that such transactions result in the recognition of gain or loss to the parent corporation on the appreciation in the stock (that is, on the "outside" gain). There is a potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the "inside" assets of the corporation. (In many cases, however, the "outside" gain may be less than the "inside" gain; furthermore, the deferral of such "inside" gain may significantly reduce any actual economic multiple corporate taxation effect.) Congress believed it was appropriate to permit an election to recognize the inside gain immediately in lieu of the outside gain, thus in effect treating the transaction as a transfer of the underlying assets. Such an election was already available under prior law in some circumstances under section 338(h)(10).[63] However, this election was not available, for example, when the subsidiary did not file a consolidated return with the selling shareholder, or when the stock of the subsidiary was distributed to shareholders.[64] Congress granted regulatory authority to the Treasury Department to expand the scope of the election to treat the sale of a corporation's stock as a sale of its underlying assets to include sales not covered by section 338(h)(10) and distributions of stock in a controlled subsidiary.

Explanation of Provisions

Overview

The Act provides that gain or loss generally is recognized by a corporation on liquidating distributions of its property as if the property had been sold at fair market value to the distributee. Gain or loss is also recognized by a corporation on liquidating sales of its property. Exceptions are provided for distributions in which an 80-percent corporate shareholder receives property with a carryover basis in a liquidation under section 332, and certain distributions and exchanges involving property that may be received tax-free by the shareholder under subchapter C of the Code.

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[61] *See* secs. 311 and 336 as amended by the Act. *See also* 361 as amended by the Act.

[62] In amending section 311 in 1984, Congress determined that the existence of a carryover basis in the hands of a corporate distributee, even where the distributee was a member of the same affiliated group, did not justify nonrecognition for nonliquidating distributions. Nonliquidating distributions present opportunities for selective transfer of gain or loss that were not believed to be present in a corporate liquidation qualifying for relief. *See* H. Rep. 98-861 (June 23, 1984), p. 821.

[63] As discussed above, section 338(h)(10) permits an election under which the selling corporation's gain on the sale of its subsidiary's stock is ignored, and gain is recognized by the subsidiary as if it had sold its assets in a taxable sale and then liquidated in a section 332 liquidation.

[64] Distributions of subsidiary stock may qualify for nonrecognition at both the corporate and shareholder levels if the requirements of section 355 are met. However, specific statutory requirements, including a five-year active business test, must be met before section 355 is applicable.

The Act also makes certain conforming changes in the provisions relating to nonliquidating distributions of property to shareholders, and in the provisions relating to corporations taxable under subchapter S.

Distributions in Complete Liquidation

General rule

The Act provides that, in general, gain or loss is recognized to a corporation on a distribution of its property in complete liquidation. The distributing corporation is treated as if it had sold the property at fair market value to the distributee-shareholders.

If the distributed property is subject to a liability, the fair market value of the property for this purpose is deemed to be no less than the amount of the liability. Thus, for example, if the amount of the liability exceeds the value of the property that cures it, the selling corporation will recognize gain in an amount equal to the excess of the liability over the adjusted basis of the property.[65] Likewise, if the shareholders of the liquidating corporation assume liabilities of the corporation and the amount of liabilities assumed exceeds the fair market value of the distributed property, the corporation will recognize gain to the extent the assumed liabilities exceed the adjusted basis of the property. However, the provision does not affect, and no inference was intended regarding, the amount realized by or basis of property received by the distributee-shareholders in these circumstances.

Exceptions

Section 332 liquidations[66]

An exception to the recognition rule is provided for certain distributions in connection with the liquidation of a controlled subsidiary into its parent corporation. Under new section 337 of the Code, no gain or loss is generally recognized with respect to property distributed to a corporate shareholder (an "80-percent distributee") in a liquidation to which section 332 applies. If a minority shareholder receives property in such a liquidation, the distribution to the minority shareholder is treated in the same manner as a distribution in a nonliquidating redemption. Accordingly, gain (but not loss) is recognized to the distributing corporation.[67]

The exception for 80-percent corporate shareholders does not apply where the shareholder is a tax-exempt organization unless the property received in the distribution is used by the organization in an activity, the income from which is subject to tax as unrelated business taxable income (UBTI), immediately after the distribution. If such property later ceases to be used in an activity of the organization acquiring the property, the income from which is subject to tax as UBTI, the organization will be taxed at that time (in addition to any other tax imposed, for example, on depreciation recapture under section 1245) on the lesser of (a) the built-in gain in the property at the time of the distribution, or (b) the difference between the adjusted basis of the property and its fair market value at the time of the cessation.

The exception for liquidations into a controlling corporate shareholder is also inapplicable where the parent is a foreign corporation. The Act amends section 367 of the Code to require recognition in a liquidation into a controlling foreign corporation, unless regulations provide otherwise. Congress expected that such regulations may permit nonrecognition if the potential gain on the distributed property at the time of the distribution is not being removed from the U.S. taxing jurisdiction prior to recognition.

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[65] *See also* section 7701(g) of the Code, providing that an identical rule for nonrecourse debt applies with respect to any Code provision (including secs. 336 and 311) in which the amount of gain realized with respect to certain transfers or dispositions is determined by specific reference to the fair market value of the property directly or indirectly disposed of. Treas. Reg. secs. 1.1001-1 and 1.1001-2 also provide generally for the treatment of transfers in which recourse or nonrecourse liabilities are involved. As under these provisions, Congress did not intend to require that any liabilities incurred by reason of the acquisition of property that were not taken into account in determining the transferor's basis for such property be taken into account in determining the amount of gain or loss under this provision.

[66] Congress anticipated that, in a consolidated return context, the Treasury Department will consider whether aggregation of ownership rules similar to those in sec. 1.1502-34 of the regulations should be provided for purposes of determining a corporation's status as an 80-percent distributee.

[67] *See* sec. 336(d)(3) of the Code, as amended by the Act.

If gain is recognized on a distribution of property in a liquidation described in section 332(a), a corresponding increase in the distributee's basis in the property will be permitted.[68]

The Act relocates the provisions of section 332(c) to section 337(c) of the Code. Distributions of property to the controlling parent corporation in liquidations to which section 332 applies in exchange for debt obligations of the subsidiary are treated in the same manner as distributions in exchange for stock of the subsidiary, as under prior law section 332(c).

Tax-free reorganizations and distributions

The general rule requiring gain or loss recognition on liquidating distributions of property is inapplicable to transactions governed by Part III of subchapter C of the Code, relating to corporate organizations and reorganizations, to the extent the recipient may receive the property without recognition of gain (i.e., to the extent the recipient does not receive "boot").[69] In addition, the provision is not intended to apply to nonreorganization transactions described in section 355 of the Code to the extent the recipient may receive the distribution without recognition of gain under Part III of subchapter C.[70] Thus, on a liquidating distribution of boot in a transaction qualifying under section 355 that is not pursuant to a plan of reorganization, the distributing corporation recognizes gain (but not loss) with respect to any "boot" distributed to shareholders.[71]

Limitations on recognition of losses

The Act includes two provisions designed to prevent inappropriate corporate-level recognition of losses on liquidating dispositions of property. In enacting these provisions, Congress did not intend to create any inference regarding the deductibility of such losses under other statutory provisions or judicially created doctrines, or to preclude the application of such provisions or doctrines where appropriate.[72]

Distributions to related persons

Under the first loss limitation rule, a liquidating corporation may not recognize loss with respect to a distribution of property to a related person within the meaning of section 267,[73] unless (i) the property is distributed to all shareholders on a pro rata basis and (ii) the property was not acquired by the liquidating corporation in a section 351 transaction or as a contribution to capital during the five years preceding the distribution.

Thus, for example, a liquidating corporation may not recognize loss on a distribution of recently acquired property to a shareholder who, directly or indirectly, owns more than 50 percent in value of the stock of the corporation. Similarly, a liquidating corporation may not recognize a loss on any property, regardless of when or how acquired, that is distributed to such a shareholder on a nonpro rata basis.

Dispositions of certain carryover basis property acquired for tax-avoidance purposes

Under the second loss limitation rule, recognition of loss may be limited if property whose adjusted basis exceeds its value is contributed to a liquidating corporation, in a carryover basis transaction, with a principal purpose of recognizing the loss upon the sale or distribution of the property (and thus eliminating or otherwise limiting corporate level gain). In these circumstances, the basis of

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[68] A technical correction may be needed so that the statute reflects this intent.

[69] Section 361 provides rules governing the treatment of certain distributions in a reorganization. Under amended section 361, sections 336 and 337 do not apply to distributions of property pursuant to a plan of reorganization.

[70] A technical correction may be needed so that the statute reflects this intent.

[71] A technical correction may also be needed to clarify that the distributing corporation recognizes gain but not loss on a distribution of boot in these circumstances.

[72] *See, e.g.*, section 482 and Treas. Reg. section 1.482-1(d)(5); *National Securities Corp. v. Comm'r*, 137 F.2d 600 (3d Cir. 1943), *aff'g* 46 B.T.A. 562 (1942), *cert. denied*, 320 U.S. 794 (1943) (loss on sale by subsidiary of securities transferred by parent in nonrecognition transaction reallocated to parent, where purpose of transfer was to shift unrealized loss on securities to subsidiary); *Court Holding Co. v. U.S.*, 324 U.S. 321 (1945) (corporation treated as true seller of property distributed to shareholders and purportedly sold by them to third party); and *Gregory v. Helvering*, 293 U.S. 465 (1935) (in addition to meeting literal requirements of statute, transaction must have valid business purpose to qualify for nonrecognition).

[73] This was intended to refer to a person having a relationship to the distributing corporation that is described in section 267(b).

the property for purposes of determining loss is reduced, but not below zero, by the excess of the adjusted basis of the property on the date of contribution over its fair market value on such date.[74]

This provision was not intended to override section 311(a). Thus, if property is distributed in a nonliquidating context, the entire loss (and not merely the built-in loss) will be disallowed.

If the adoption of a plan of complete liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by this provision is filed, except as provided in regulations, the liquidating corporation will recapture the disallowed loss on the tax return for the taxable year in which such plan of liquidation is adopted. In the alternative, regulations may provide for the corporation to file an amended return for the taxable year in which the loss was reported.[75]

Example

The application of the basis reduction rule can be illustrated by the following example:

Assume that on June 1, 1987, a shareholder who owns 10 percent of the stock of a corporation (which is a calendar year taxpayer) participates with other shareholders in a contribution of property to the corporation that qualifies for nonrecognition under section 351, contributing nondepreciable property with a basis of $1,000 and a value of $100 to the corporation. Also assume that a principal purpose of the acquisition of the property by the corporation was to recognize loss by the corporation and offset corporate-level income or gain in anticipation of the liquidation. On September 30, 1987, the corporation sells the property to an unrelated third party for $200, and includes the resulting $800 loss on its 1987 tax return. Finally, the corporation adopts a plan of liquidation on December 31, 1988.

For purposes of determining the corporation's loss on the sale of the property in 1987, the property's basis is reduced to $100—that is, $1,000 (the transferred basis under section 362) minus $900 (the excess of the property's basis over its value on the date of contribution). No loss would be realized on the sale, since the corporation received $200 for the property. Likewise, the corporation would recognize no gain on the sale, since its basis for purposes of computing gain is $1,000. Congress expected that regulations might provide for the corporation to file an amended return for 1987 reflecting no gain or loss on the sale of the property. Otherwise, the corporation would be required to reflect the disallowance of the loss by including the amount of the disallowed loss on its 1988 tax return.[76]

Presumption of tax-avoidance purpose in case of contributions within two years of liquidation

For purposes of the loss limitation rule, there is a statutory presumption that the tax-avoidance purpose is present with respect to any section 351 transfer or contribution to capital of built-in loss property within the two-year period prior to the adoption of the plan of liquidation (or at any time thereafter). Although Congress recognized that a contribution more than two years before the adoption of a plan of liquidation might have been made for such a tax-avoidance purpose, Congress also recognized that the determination that such purpose existed in such circumstances might be difficult for the Internal Revenue Service to establish and therefore as a practical matter might occur infrequently or in relatively unusual cases.

Congress intended that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property within two years of the adoption of a plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises.

A clear and substantial relationship between the contributed property and the conduct of the corporation's business enterprises would generally include a requirement of a corporate business purpose for placing the property in the particular corporation to which it was contributed, rather than retaining the property outside that corporation. If the contributed property has a built-in loss at the time of contribution that is significant in amount as a proportion of the built-in corporate gain at that time, special scrutiny of the business purpose would be appropriate.

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[74] The effect of the rule is to deny recognition to the liquidating corporation of that portion of the loss on the property that accrued prior to the contribution, but to permit recognition of any loss accruing after the contribution. In the event that a transaction is described both in section 336(d)(1) and section 336(d)(2), section 336(d)(1) will prevail.

[75] A technical correction may be needed so that the statute reflects the intention that recapture in the year of liquidation is required unless regulations provide otherwise.

[76] *See* footnote 87 *supra*.

As one example, assume that A owns Z Corporation which operates a widget business in New Jersey. That business operates exclusively in the northeastern region of the United States and there are no plans to expand those operations. In his individual capacity, A had acquired unimproved real estate in New Mexico that has declined in value. On March 22, 1988, A contributes such real estate to Z and six months later a plan of complete liquidation is adopted. Thereafter, all of Z's assets are sold to an unrelated party and the liquidation proceeds are distributed. A contributed no other property to Z during the two-year period prior to the adoption of the liquidation. Because A contributed the property to Z less than two years prior to the adoption of the plan of liquidation, it is presumed to have been contributed with a prohibited purpose. Moreover, because there is no clear and substantial relationship between the contributed property and the conduct of Z's business, Congress did not expect that any loss arising from the disposition of the New Mexico real estate would be allowed under the Treasury regulations.

However, Congress expected that such regulations will permit the allowance of any resulting loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation where prior law would have permitted the allowance of the loss and the clear and substantial relationship test is satisfied. In such circumstances, application of the loss disallowance rule is inappropriate assuming there is a meaningful (i.e., clear and substantial) relationship between the contribution and the utilization of the particular corporate form to conduct a business enterprise. If the contributed business is disposed of immediately after the contribution, it is expected that it would be particularly difficult to show that the clear and substantial relationship test was satisfied. Congress also anticipated that the basis adjustment rules will generally not apply to a corporation's acquisition of property as part of its ordinary start-up or expansion of operations during its first two years of existence. However, if a corporation has substantial gain assets during its first two years of operation, a contribution of substantial built-in loss property followed by a sale or liquidation of the corporation would be expected to be closely scrutinized.

Conversions from C to S Corporation Status

The Act modifies the treatment of an S corporation that was formerly a C corporation. A corporate-level tax is imposed on any gain that arose prior to the conversion ("built-in" gain) and is recognized by the S corporation, through sale, distribution, or other disposition[77] within ten years after the date on which the S election took effect. The total amount of gain that must be recognized by the corporation, however, is limited to the aggregate net built-in gain of the corporation at the time of conversion to S corporation status.[78] Congress expected that the Treasury Department could prevent avoidance of the built-in gain rule by contributions of built-in loss property prior to the conversion for the purpose of reducing the net built-in gain.

Gains on sales or distributions of assets by the S corporation are presumed to be built-in gains, except to the extent the taxpayer establishes that the appreciation accrued after the conversion, such as where the asset was acquired by the corporation in a taxable acquisition after the conversion. Built-in gains are taxed at the maximum corporate rate applicable to the particular type of income (i.e., the maximum rate on ordinary income under section 11 or, if applicable, the alternative rate on capital gain income under section 1201) for the year in which the disposition occurs. The corporation may take into account all of its subchapter C tax attributes in computing the amount of the tax on recognized built-in gains. Thus, for example, it may use unexpired net operating losses, capital loss carryovers, and similar items to offset the gain or the resulting tax.[79]

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[77] For the particular purposes of this built-in gain tax under new section 1374, Congress intended the term "disposition of any asset" to include not only sales or exchanges but other income-recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income. For instance, the term "disposition of any asset" for purposes of this provision will include the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

[78] Congress intended that the recognized built-in gains taken into account for any taxable year shall not exceed the excess, if any, of (a) the net unrealized built-in gain at the time of the conversion, over (b) the amount (if any) by which recognized built-in gains for prior taxable years beginning in the recognition period exceed recognized built-in losses for such years.

[79] A technical correction may be needed so that the statute reflects this intent in the case of capital loss carryovers and similar items.

Congress intended that in a carryover basis transfer of property with built-in gain to an S corporation from a C corporation, the built-in gain with respect to property will be preserved in the hands of the transferee for the 10-year period. Similarly, in the case of a transfer of built-in gain property in a substituted basis transaction, the property received by the transferor will assume the built-in gain taint of the transferred property. If a C corporation converts to S status and is subject to the built-in gain rule, built-in gain assets that such corporation transfers to another S corporation in a carryover basis transaction will retain their original 10-year taint in the hands of the transferee.

Regulatory Authority to Prevent Circumvention of* General Utilities *Repeal

The repeal of the *General Utilities* rule is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context. Congress expected the Treasury Department to issue, or to amend, regulations to ensure that the purpose of the new provisions (including the new subchapter S built-in gain provisions) is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (Part III of subchapter C) or through the use of other pass-through entities such as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this would include rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT in a carryover basis transaction that would otherwise eliminate corporate-level tax on the built-in appreciation.

Application of Other Statutory Rules and Judicial Doctrines

In providing for recognition of gain on liquidating distributions, Congress did not intend to supersede other existing statutory rules and judicial doctrines, including (but not limited to) section 1245 and 1250 recapture, the tax benefit doctrine, and the assignment of income doctrine. Accordingly, these rules will continue to apply to determine the character of gain recognized on liquidating distributions where they are otherwise applicable.

Nonliquidating Distributions

The Act makes certain conforming changes to the provisions relating to nonliquidating distributions of property. For purposes of determining the amount realized on a distribution of property, the fair market value of the property is treated as being no less than the amount of any liability to which it is subject or which is assumed by the shareholder under the principles applicable to liquidating distributions. The prior-law exceptions to recognition that were provided for nonliquidating distributions to ten percent, long-term noncorporate shareholders, and for certain distributions of property in connection with the payment of estate taxes or in connection with certain redemptions of private foundation stock, are repealed. As under prior law, no loss is recognized to a distributing corporation on a nonliquidating distribution of property to its shareholders.

Election to Treat Sale or Distribution of Subsidiary Stock as Disposition of Subsidiary's Assets

The Act generally conforms the treatment of liquidating sales and distributions of subsidiary stock to the prior-law treatment of nonliquidating sales or distributions of such stock; thus, such liquidating sales or distributions are generally taxable at the corporate level. Congress believed it was appropriate to conform the treatment of liquidating and nonliquidating sales or distributions and to require recognition when appreciated property, including stock of a subsidiary, is transferred to a corporate or individual recipient outside the economic unit of the selling or distributing corporation.

However, Congress believed it was appropriate to provide relief from a potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the assets of the corporation. In addition to retaining the election available under section 338(h)(10) of prior law, the Act permits the expansion of the concept of that provision, to the extent provided in regulations, to dispositions of a controlling interest in a corporation for which this election is currently unavailable. For example, the election could be made available where the selling corporation owns 80 percent of the value and voting power of the subsidiary but does not file a consolidated return with the subsidiary. Moreover, the Act provides that, under regulations, principles similar to those of section 338(h)(10) may be applied to taxable distributions of controlled corporation stock.[80]

[80] The Act provides in the case of a sale or distribution of stock of a subsidiary by a qualifying parent corporation, that under regulations "such corporation" may make the election. Congress did not intend to require the election to be made unilaterally. Compare section 338(h)(10).

Congress intended that the regulations under this elective provision will account for appropriate principles that underlie the liquidation-reincorporation doctrine. For example, to the extent that regulations make available an election to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of section 368(a)(2)(H) (i.e., section 304(c)), it may be appropriate to provide special rules for such corporation's section 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed.

Congress did not intend this election to affect the manner in which a corporation's distribution to its shareholders is characterized for purposes of determining the shareholder-level income tax consequences.

Treasury Study of Subchapter C

The Act directs the Treasury Department to consider whether changes to the provisions of subchapter C (relating to the income taxation of corporations and their shareholders) and related sections of the Code are desirable, and to report to the tax-writing committees of Congress no later than January 1, 1988.

Effective Dates

In General

The repeal of the *General Utilities* rule is generally effective for liquidating sales and distributions after July 31, 1986. The Act provides a number of general transitional rules, some of which are based on action before November 20, 1985 (the date of action by the House Ways and Means Committee), some of which are based on action before August 1, 1986 (the date of action by the conference committee), and some of which are based on actions after July 31, 1986, and before January 1, 1987. The amendments made by the Act are inapplicable to transactions covered by these general transitional rules.

In addition to these general transitional rules, the Act provides a special delayed effective date for transactions involving certain closely held corporations of limited size. With certain modifications, these transactions are also subject to prior-law rules.

General Transitional Rules Based on Pre-November 20, 1985 Action

The amendments made by the Act do not apply to distributions or sales and exchanges made pursuant to a plan of liquidation adopted before November 20, 1985, provided the liquidation is completed before January 1, 1988. Special rules apply in determining whether a plan of liquidation was adopted for purposes of these transitional rules[81] and whether a distribution, sale, or exchange is made pursuant to such a plan of liquidation. In general, the rules are intended to provide relief in situations in which a decision to liquidate has clearly been made regarding an acquisition, or a decision regarding acquisition has been made and the essential terms have been determined. Some transactions may qualify for relief under more than one provision. A liquidation will be treated as completed under the same standard that is applied under the general transitional rules for liquidations before January 1, 1987.

First rule

The first rule under which a distribution, sale, or exchange is treated as pursuant to a plan of liquidation adopted before November 20, 1985, looks to action taken by the liquidating company before the November 20 date. If the board of directors of that company adopted a resolution to solicit shareholder approval for a transaction described in section 336 or 337 of prior law[82] or if the shareholders or board of directors of the liquidating company have approved such a transaction, then distributions, sales and exchanges that occur pursuant to the transaction are not subject to the Act provided that the liquidation is completed before January 1, 1988.

[81] These special rules do not apply, however, for purposes of the transitional rules based on pre-August 1, 1986, action.

[82] For purposes of these transitional rules generally, transactions described in section 336 or 337 of prior law include complete liquidations and the related distributions, sales, or exchanges described in those sections.

Pre-November 20 action

For purposes of this first rule, certain actions taken before November 20, 1985, were intended to constitute implicitly the necessary board of directors or shareholder approval even though formal board or shareholder approval may not otherwise have occurred before that date. Congress intended the requisite board or shareholder approval will be deemed to have occurred if, before November 20, 1985, there was sufficient written evidence to establish that a decision to liquidate has been approved by the board of directors or shareholders, even though the approval may have been given informally, as may occur, for example, in a closely held setting. Examples of sufficient written evidence include written contacts with third parties indicating the decision to liquidate and seeking any necessary approvals for asset transfers or for other actions in connection with the liquidation.

Congress also intended that the requisite board or shareholder approval would be deemed to have occurred, if a company had, before November 20, 1985, entered into a binding contract to sell substantially all of its assets, or entered into a letter of intent with a buyer specifying the essential terms of such a contract.[83] Similarly, the requisite approval would be deemed to have occurred if, before the relevant date, the board of directors of a corporation adopted a resolution approving or recommending the grant by its shareholders of an option to purchase a majority of the stock of the corporation; or if the shareholders granted such an option before the relevant date, if the option in each case would be a binding option as to the seller, enforceable by the optionee (purchaser).

"Pursuant to" requirement

To qualify for transitional relief, distributions, sales, or exchanges must be pursuant to the transaction that the board of directors approved, or for which it solicited shareholder authority (as described above). This will generally be presumed to be the case if a formal plan of liquidation is adopted and the distributions, or sales and exchanges pursuant to such plan commence within one year of the original shareholder or board action. If such action is not taken within a year of such time, all the facts and circumstances must be considered, including, for example, a decision to seek a ruling request from the Internal Revenue Service or the need to obtain governmental rulings or approvals, or third party approvals for asset transfers. If the requisite shareholder or board approval is reflected in a binding contract or letter of intent, the specified sale must thereafter be consummated in accordance with the contract or letter of intent and the formal plan of liquidation be adopted as required above.

Second rule

Under a second rule relating to pre-November 20, 1985 action, sales or distributions pursuant to a plan of liquidation (which includes, for purposes of this purpose, a section 338 election) are not affected by the Act if, before November 20, 1985, (i) there was an offer to purchase a majority of the voting stock of the liquidating corporation, or (ii) the board of directors of the liquidating corporation has adopted a resolution approving an acquisition of the company or recommending the approval of an acquisition of the company to the shareholders; provided in each case the sale or distribution is pursuant to or was contemplated by the terms of the offer or resolution, and a complete liquidation occurs (or the section 338 acquisition date, with respect to which a section 338 election is made) before January 1, 1988. The term "liquidating corporation" includes an acquired corporation (and affiliates) with respect to which a section 338 election is made.

Pre-November 20 action

An offer to purchase a majority of the stock of a corporation is intended to include a tender offer or a binding option given by the offeror and enforceable by the offeree. An offer also includes a letter of intent entered into by the purchaser and seller specifying the essential terms of an acquisition. Any binding contract to acquire a corporation presupposes an offer (as well as the approval and

[83] As an example, if prior to November 20, 1985, the company had entered a letter of intent specifying that either substantially all the assets of the company will be sold to a particular purchaser or purchasers for a particular price, or that all the stock of the company will be sold to such persons (who may then liquidate the corporation or make a section 338 election), it will generally be considered that the requisite shareholder or board approval of a transaction described in section 337 of prior law occurred if the contract to sell assets was in fact entered and the corporation liquidates in a transaction described in section 337 before 1988. The same transaction could qualify under the transitional rule for an offer to acquire stock if the contract to sell stock were entered into (and the purchaser made a section 338 election with respect to a pre-1988 acquisition date, or liquidated the corporation before 1988).

acceptance of the required corporation's shareholders or board of directors). Congress did not intend that a nonbinding offer, as to which there has been no implicit or explicit approval by the board of directors or shareholders of the corporation to be acquired, would be within the scope of the transition rule.

"Pursuant to" requirement

For purposes of these transitional rules, in determining whether a sale or distribution is pursuant to or was contemplated as part of a transaction, Congress intended that deemed sales or exchanges pursuant to a timely section 338 election made with respect to a qualified stock purchase will be presumed to be pursuant to and contemplated by the terms of a pre-November 20, 1985 offer or of a board-approved or recommended acquisition that resulted in the purchase. For example, if, prior to November 20, 1985, the board of directors of a corporation adopted a resolution approving the acquisition of that corporation and if, after November 20, 1985, the acquisition occurs and a timely section 338 election is made prior to January 1, 1988 with respect to the acquired company and its affiliates, the deemed sales pursuant to the section 338 election will not be affected by the Act. In addition, if a corporation qualifies for this transitional rule by virtue of a letter of intent or binding contract, the acquisition must occur in accordance with the letter or contract.

Congress also intended that distributions, sales or exchanges will generally be considered pursuant to and contemplated by an acquisition transaction if a formal plan of liquidation is adopted within one year after the acquisition is consummated and the distributions, sales, or exchanges commence within that time. However, Congress intended that if such actions commence more than one year after the acquisition, a determination whether the distributions, sales, or exchanges are pursuant to or were contemplated by the terms of the offer will be determined on the basis of all the facts and circumstances. Such circumstances include, but are not limited to, references to or statements regarding the possibility of a liquidation made in the acquisition documents, proxy material, or other correspondence with shareholders, public announcements, or requests for governmental approvals, as well as internal documentation and correspondence with attorneys or others involved in the acquisition.

Third rule

Under the third rule relating to pre-November 20, 1985 action, distributions, sales, or exchanges in a liquidation (including a section 338 election) are not affected by the amendments under the Act if, prior to that date, a ruling request was submitted to the Internal Revenue Service with respect to a transaction (which transaction includes or contemplates a transaction described in section 336 or 337 of prior law (including a section 338 election)), and, pursuant to the transaction described in the ruling request, a plan of complete liquidation is adopted (or a sec. 338 election made) and the liquidation is completed (or the section 338 acquisition date occurs before January 1, 1988).

Related corporations

In applying the foregoing rules, action (as described above) taken by the board of directors or shareholders of a corporation with respect to a subsidiary of such corporation is treated as taken by the board of directors or shareholders of such subsidiary. For example, if the board of directors of a parent corporation adopted a resolution approving the sale of substantially all the assets and subsequent liquidation of the subsidiary, that action will be considered action of the shareholders and board of the subsidiary regardless of how many tiers below the parent the subsidiary may be (so long as the parent has effective control over the subsidiary).

In certain instances involving a group of several tiers of subsidiaries, even though the parent corporation has not formally adopted such a resolution, the action of a lower-tier subsidiary may be considered evidence of implicit action by the parent. For example, in the case of the liquidation of a group of corporations constituting an affiliated group involving sales under prior-law section 337, all distributee members of the group must liquidate within one year. If one member of such group has prior to November 20, 1985, taken board or shareholder action of the type qualifying for transition relief (as described above) and if that member and the other members do liquidate within the required one year period, it was intended that timely approval by the board or shareholders of the parent corporation of the group will generally be presumed. In other situations involving pre-November 20 action by only one member of a group of commonly controlled corporations, whether that action can be attributed to members of the group other than an effectively controlled subsidiary of the acting corporation will be determined on the basis of all the facts and circumstances.

General Transitional Rules Based on Pre-August 1, 1986 or Pre-January 1, 1987 Action

The amendments made by the Act also do not apply to transactions which do not meet the requirements of the general transitional rules based on pre-November 20, 1985 action, but which are described in one or more of the following categories:

(1) a liquidation completed before January 1, 1987;

(2) a deemed liquidation pursuant to a section 338 election where the acquisition date (the first date on which there is a qualified stock purchase under section 338) occurs before January 1, 1987;[84]

(3) a liquidation pursuant to a plan of liquidation adopted before August 1, 1986, that is completed before January 1, 1988;

(4) a liquidation if a majority of the voting stock of the corporation is acquired on or after August 1, 1986, pursuant to a written binding contract in effect before August 1, 1986, and if the liquidation is completed before January 1, 1988;

(5) a liquidation if there was a binding written contract or contracts to acquire substantially all the assets of the corporation in effect before August 1, 1986, and the liquidation is completed before January 1, 1988; and

(6) a deemed liquidation, under section 338, of a corporation for which a qualified stock purchase under section 338 first occurs on or after August 1, 1986, pursuant to a written binding contract in effect before August 1, 1986, provided the section 338 acquisition date occurs before January 1, 1988.

Rules applicable in determining when plan of liquidation adopted

A plan of liquidation is adopted if the plan has been approved by the shareholders (see Treas. Reg. sec. 1.337-2(b)). If a plan of liquidation would have been considered adopted for purposes of commencing the twelve-month period under prior-law section 337, it will be deemed adopted for this purpose.

Rules applicable in determining whether binding contract in effect of August 1, 1986

For purposes of determining whether there was a binding contract or contracts to sell substantially all of the assets of a corporation before August 1, 1986, the term "substantially all of the assets" shall generally mean 70 percent of the gross fair market value and 90 percent of the net fair market value of the assets. In addition, even though the contract or contracts cover a lesser amount of assets, if such contract or contracts would require shareholder approval under the applicable state law that may require such approval for a sale of substantially all of such corporation's assets, then they will qualify as contracts to sell substantially all the assets and will be considered binding even though shareholder approval has not yet been obtained.

An acquisition of stock or assets will be considered made pursuant to a binding written contract even though the contract is subject to normal commercial due diligence or similar provisions and the final terms of the actual acquisition may vary pursuant to such provisions.

For purposes of these rules, a liquidation is completed by a required date if it would be considered completed for purposes of section 337 of prior law by that date. For example, there may be a distribution of assets to a qualified liquidating trust (See, e.g., Rev. Rul. 80-150, 1980-1 C.B. 316).

Amendments to Provisions Relating to Nonliquidating Distributions

In general, the conforming amendments to section 311 are effective for distributions after July 31, 1986.

Amendments to Provisions Relating to Subchapter S Corporations

The provisions relating to S corporations that were formerly C corporations are generally effective with respect to returns filed pursuant to S elections made after December 31, 1986.[85] Thus, in the case

[84] If the "acquisition date" under section 338 occurs before the relevant transition date, the prior law provision allowing additional stock to be purchased within a year after the section 338 "acquisition date" is also available. Thus, if there is a qualified stock purchase of 80 percent of the stock of a qualified corporation on December 1, 1986, followed by purchase of the remaining 20 percent on February 1, 1987, the nonrecognition percentage for purposes of section 337 of prior law would be 100 percent. *See* section 338(c)(1) and Prop. Treas. Reg. section 1.338-4T(k)(5).

[85] For purposes of the transition provisions, if a corporation was a C corporation at any time before December 31, 1986, any "S" status of such a corporation prior to its "C" corporation status is disregarded in determining whether under the statute the first taxable year for which the corporation is an S corporation is pursuant to an S election made after December 31, 1986.

of S corporations whose election was made before January 1, 1987, the prior-law version of section 1374 will apply. For example, if such an S corporation is liquidated after December 31, 1986, and within 3 years of converting from C to S status, new section 1363 and new section 336 will apply (subject to special transition rules for certain closely held corporations) to require the recognition of gain on the liquidation. If there is capital gain of sufficient amount, prior law section 1374 will impose a corporate level tax on that gain in liquidation.

Delayed Effective Dates for Certain Closely held Corporations

In general

Special delayed effective dates are provided for certain closely held corporations that are limited in size.[86] Corporations eligible for this rule are generally entitled to prior-law treatment with respect to liquidating sales and distributions occurring before January 1, 1989, provided the liquidation is completed before that date. A liquidation will be treated as completed under the same standard that is applied under the general transitional rules. However, this special transitional rule requires the recognition of income on distributions of ordinary income property (appreciated property that would not produce capital gain if disposed of in a taxable transaction) and short-term capital gain property. Thus, the failure of an eligible closely held corporation to complete its liquidation by December 31, 1986, or otherwise to satisfy the general transitional rules, will result in the loss of nonrecognition treatment for the distribution of appreciated ordinary income and short-term capital gain property. It will also require recognition on distributions of installment obligations that are received in exchange for such property. Congress did not intend to require corporate level recognition on distribution of installment obligations that are received in exchange for long-term capital gain property (including section 1231 property the disposition of which would produce long-term capital gain) where the distribution of such obligations would not have caused recognition under prior law sections 337 and 453B(d)(2).

Corporations eligible for this rule may also make an S election prior to January 1, 1989, without becoming subject to the new rules under section 1374 relating to built-in gains except with respect to ordinary income and short-term capital gain property (it is not necessary that such a corporation liquidate prior to January 1, 1989).[87] However, a corporation having a value in excess of $5 million (but not in excess of $10 million), is subject to a phase-out of this relief. Thus, in such circumstances new section 1374 will apply to a portion of the built-in long-term capital gain. Prior law section 1374 will apply to any portion of the built-in long-term capital gains not subject to new section 1374. In addition, to the extent a corporation is eligible for relief under the small corporation rule, a portion of any other long-term capital gain that would be covered by prior law section 1374 (whether or not built-in at the time of conversion) will continue to be covered by that section.

A taxpayer that purchases the stock of a qualified corporation in a qualified stock purchase prior to that date is entitled to apply prior-law rules (modified as in the case of actual liquidations) with respect to an election under section 338, even though in the hands of the acquiring corporation the qualified corporation no longer satisfies the stock holding period requirements and may not satisfy the size or shareholder requirements due to the size or shareholders of the acquiring corporation.[88]

Although the Act repeals section 333, in the case of a liquidating distribution to which section 333 of prior law would apply a shareholder of a qualified corporation electing such treatment is entitled to apply section 333 without any phase-out of shareholder level relief under the Act. However, an increase in shareholder-level gain could result from an increase in corporate earnings and profits resulting from application of the corporate-level phase-out of relief from repeal of *General Utilities*.

Finally, for distributions prior to January 1, 1989, qualifying corporations continue to be eligible for relief under prior-law rules relating to nonliquidating distributions with respect to qualified stock (sec. 331(d)(2)). However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

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[86] *See* Act section 633(d).

[87] A technical correction may be needed to clarify that the election need only be made (not become effective) by this date. Such a correction was included in H. Con. Res. 395 as passed by the House and Senate in the 99th Congress.

[88] A technical correction may be needed so that the statute reflects this intent.

Requirements for qualification

A corporation is eligible for these special delayed effective dates if it was in existence on August 1, 1986, its value does not exceed $10 million, and more than 50 percent (by value) of the stock[89] in such corporation is owned by ten or fewer individuals who have held such stock for five years or longer (or the life of the corporation, if less than five years).[90] Full relief is available under this rule only if the corporation's value does not exceed $5 million; relief is phased out for corporations with values between $5 million and $10 million. For purposes of this rule, a corporation's value will be the higher of the value on August 1, 1986, or its value as of the date of adoption of a plan of liquidation (or, in the case of a nonliquidating distribution, the date of such distribution).

Congress intended that, where stock passes to an estate, the holding period of the estate includes that of the decedent. Also, it was intended that the "look-through" attribution rules, generally applicable where stock is held by an entity, would not apply in the case of trusts qualifying under section 1361(c)(2)(ii) or (iii) just as they do not apply under the statute in the case of estates. Thus, stock held by such entities, like stock held by an estate, is to be treated as held by a single qualified person, so that the 10 shareholder test will not cease to be satisfied merely because a decedent's stock passes to such a trust. (In the case of other trusts holding stock, it was intended that the "look-through" attribution rules would apply to determine whether more than 10 qualified persons ultimately own stock.) It was also intended that the holding period of a decedent's estate (or a 1361(c)(2)(ii) or (iii) trust) would be tacked with that of a beneficiary who would have been treated as "one person" with the decedent under the applicable attribution rules. Technical corrections may be needed so that the statute reflects such intent.

In the case of indirect ownership attributed through another entity (for example, a corporation or a partnership), Congress did not intend the rules of section 1223 to apply in all cases for purposes of determining the holding period of the qualified person. In such cases, the qualified person's holding period is the lesser of (1) the period during which the entity held the stock in the qualified corporation, or (2) the period during which the qualified person held the interest in the entity. In the case of holdings through tiers of entities, similar rules apply at each level in determining the holding period of intermediate entities. A technical correction may be necessary so that the statute reflects this intent.

Aggregation rules similar to those in section 1563 apply for purposes of determining the value of the corporation on the relevant date, except that control is defined as more than 50 percent rather than 80 percent. Thus, the value of a corporation for purposes of this transitional rule includes the value of other corporations that are (or were) members of its controlled group on the relevant date, including corporations that were completely liquidated prior to January 1, 1987. In providing that all members of the same controlled group of corporations are treated as a single corporation for purposes of this rule, however, Congress did not intend to require that all corporations in a controlled group that would qualify for relief be liquidated in order for the liquidation of any one or more corporations in the group to qualify for relief.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $15 million in 1987, $180 million in 1988, $348 million in 1989, $460 million in 1990, and $551 million in 1991.

CANCELLATION OF INDEBTEDNESS FOR SOLVENT TAXPAYERS (SEC. 822 OF THE ACT AND SEC. 108 OF THE CODE)[91]

Prior Law

Under both present and prior law, gross income includes "income from discharge of indebtedness" (sec. 61(a)(12)). A discharge of indebtedness is considered to occur whenever a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt.

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[89] *See* Act section 633(d)(5)(A).

[90] A technical correction may be needed so that the statute reflects the holding period requirement. A similar correction was included in H. Con. Res. 395 as passed by the House and Senate in the 99th Congress.

[91] For legislative background of the provision, *see*: H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 323; S.Rep. 99-313, pp. 161–162; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 324–325 (Conference Report).

The amount of indebtedness discharged is equal to the difference between the face amount of the debt, adjusted for any unamortized premium or discount, and any consideration given by the taxpayer to effect the discharge. Both present and prior law contain exceptions to the general rule in cases where the discharge occurs in a case arising under Title 11 of the United States Code (relating to bankruptcy) or when the taxpayer is considered to be insolvent.

Prior law also provided an exception where the indebtedness discharged was qualified business indebtedness (sec. 108(a)(1)). Qualified business indebtedness was indebtedness that was incurred or assumed by a corporation or indebtedness that was incurred or assumed by an individual in connection with property used in the individual's trade or business. A taxpayer was required to elect to have the indebtedness treated as qualified business indebtedness (sec. 108(d)(4)).

In the case of a discharge of qualified business indebtedness, the amount of the discharge that would have been included in gross income had the discharge not been of qualified business indebtedness was instead applied to reduce the basis of depreciable property of the taxpayer (sec. 108(c)(1)). An election was available to treat inventory as depreciable property for this purpose. The amount of discharge income that could have been excluded as a discharge of qualified business indebtedness was limited to the basis of the taxpayer's depreciable property. If the amount of discharge income exceeded the basis of depreciable property, the excess was required to be included in gross income for the year in which the discharge occurred.

Reasons for Change

The Congress believed that the prior law treatment of the discharge of qualified business indebtedness was too generous. Income from such a discharge generally was deferred by reducing the basis of depreciable assets, regardless of the capacity of the taxpayer to currently pay the tax. In addition, the provision produced disparate results among taxpayers depending upon the makeup of their depreciable assets. For taxpayers without sufficient amounts of inventory or depreciable assets, the full benefit of the deferral was not available.

Explanation of Provision

The Act repeals the provision of prior law (sec. 108(a)(1)(C)) which provided for the exclusion from gross income of income from the discharge of qualified business indebtedness. The effect of the Act is to require that any discharge of indebtedness, other than a discharge in title 11 cases and a discharge that occurs when the taxpayer is insolvent, results in the current recognition of income in the amount of the discharge.

The Congress did not intend to change the present law treatment of a discharge of indebtedness that occurs in a title 11 case or when the taxpayer is insolvent.[92] The Congress also did not intend to change the provision of prior and present law (sec. 108(e)(5)) that treats any reduction of purchase-money debt of a solvent debtor as a purchase price adjustment, rather than a discharge of indebtedness.

Effective Date

The provision is applicable to discharges of indebtedness occurring after December 31, 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $60 million in 1987, $85 million in 1988, $67 million in 1989, $57 million in 1990, and $46 million in 1991.

[92] Sec. 405 of the Act provides special rules for certain solvent farmers for the purpose of determining whether there is income from the discharge of indebtedness. (*See* Title IV., Part A.4.)

APPENDIX F

Selected Provisions from the Explanation of the Technical and Miscellaneous Revenue Act of 1988

House Ways and Means Committee Report No. 100-795, July 26, 1988 ("House Committee Report")

Senate Finance Committee Report No. 100-445, August 3, 1988 ("Senate Committee Report")

Joint Committee on Taxation Explanation of Senate Consensus Amendment, JCX-28-88, September 12, 1988

Conference Committee Report, Statement of the Managers, October 24, 1988 ("Conference Committee Report")

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ACT § 1006 AND FRC § 336, 368, AND 382 SENATE COMMITTEE REPORT

SPECIAL LIMITATIONS ON NET OPERATING LOSS AND OTHER CARRYFORWARDS

Value of Loss Corporation

In lieu of regulatory authority, the bill extends the statutory rules for redemptions to other corporate contractions. The rule for redemptions was intended to apply to transactions that effect similar economic results, without regard to formal differences in the structure used or the order of events by which similar consequences are achieved. Thus, for example, the fact that a transaction might not constitute a "redemption" for other tax purposes does not determine the treatment of the transaction under this provision. As one example, a "bootstrap" acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds to the old shareholders, could generally be subject to the provision. This may include cases in which debt used to pay the old shareholders remains an obligation of an acquisition corporation or an affiliate, where the acquired loss corporation is directly or indirectly the source of funds for repayment of the obligation.

The bill also clarifies that if the old loss corporation is a foreign corporation, except as provided in regulations its value shall be determined taking into account only assets and liabilities treated as connected with the conduct of a trade or business in the United States.[1]

The provision extending the rules for redemptions to other corporate contractions applies to ownership changes occurring after June 10, 1987.

Definition of Ownership Change

The bill amends section 382(g)(4)(C) to clarify that rules similar to the segregation rule apply to acquisitions by groups of less-than-five-percent shareholders through corporations as well as other entities (e.g., partnerships), and in transactions that do not constitute equity structure shifts.

The regulatory authority in section 382(g)(3)(B) —to treat transactions under the rules for equity structure shifts—does not limit the scope of section 382(g)(4)(C). Section 382(g)(4)(C), by its terms, generally causes the segregation of the less-than-five-percent shareholders of separate entities where an entity other than a single corporation is involved in a transaction. Section 382(g)(3)(B) merely provides additional authority, as does section 382(m), for cases in which only one corporation is involved.

Special Rules for Built-In Gains and Losses and Section 338 Gains

The bill provides that a redemption or other corporate contraction occurring in connection with an ownership change that occurs on or after July 21, 1988, shall be taken into account in determining whether a loss corporation has a net unrealized built-in gain or a net unrealized built-in loss only to the extent provided in regulations. The committee was concerned that loss corporations and their acquirors would engage in redemptions and other corporate contractions in order to meet the 25 percent threshold for built-in gains, but would avoid such transactions if the loss corporation would, as a result, meet the 25 percent threshold for built-in losses. It is expected that regulations permitting a redemption or other corporate contraction to be taken into account, if any, will in no event permit a loss corporation or its acquirors to manipulate the 25 percent thresholds for net unrealized built-in and loss through selective redemptions or other corporate contractions.

The bill clarifies the treatment of built-in gain if a section 338 election is made in connection with an ownership change, and if the 25 percent built-in gain threshold was not met with respect to the ownership change, so that no post-change built-in gains would generally be allowed to increase the section 382 limitation. The bill provides that in such a case, the section 382 limitation for the post-change year in which gain is recognized by reason of the section 338 election is increased by the lesser of (i) the amount of net unrealized built-in gain (determined as of the date of the section 382 ownership change), computed without regard to the 25-percent threshold requirement, or (ii) the gain recognized by reason of section 338.

Also, regarding the allocation rule for the taxable year in which an ownership change occurs, taxable income is computed without regard to recognized built-in gains to the extent such gains increased the section 382 limitation for the year, and without regard to recognized built-in losses to the extent such losses are treated as per-change losses. That is, such gains or losses are disregarded for this purpose only to the extent they did not exceed the limitations on the total amount of recognized built-in gain or loss, as the case may be, for the year of recognition.

The amendment clarifies that any item of income which is properly taken into account during the recognition period but that is attributable to periods before the change date shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Such items would include accounts receivable of a cash basis taxpayer that arose before the change date and are collected after that date, the gain on completion of a long-term contract performed by a taxpayer using the completed contract method of accounting that is attributable to periods before the change date, and the recognition of income attributable to periods before the change date pursuant to section 481 adjustments, for example, where the loss contraction was required to change to the accrual method of accounting pursuant to Code section 448.

Also, any amount which is allowable as a deduction during the recognition period but which is attributable to periods before the change date shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction. The committee intends that this provision shall

[1] This provision relating to foreign corporations applies only to ownership changes occurring after June 10, 1987.

be effective with respect to amounts allowable as depreciation, amortization, or depletion only to the extent consistent with the special effective date provided in the Revenue Act of 1987 for such items.[2]

The amount of net unrealized built-in gain or loss shall be properly adjusted to include items of income or deduction attributable to periods before the change date.

Under the bill, except as provided in regulations, in computing net unrealized built-in gain or loss for purposes of determining whether the 25 percent threshold applies, there shall not be taken into account any (1) cash, (2) cash items (as determined for purposes of section 368(a)(2)(F)(iv), or (3) marketable securities that have a value that does not substantially differ from adjusted basis.

It is expected that regulations will generally require receivables acquired in the ordinary course of business to be treated in the same manner as other items involving built-in gain or loss, and that such receivables thus will generally be taken into account in determining whether the 25 percent threshold has been met.

On the other hand, it is expected that the Treasury Department will continue to treat receivables as items that are excluded from the computation of any 25 percent threshold, in any case where there is a potential for taxpayer manipulation of the threshold, for example, by purchasing, issuing, or otherwise acquiring receivables in a different amount or to a different extent than has previously been the case, in effect substituting a built-in gain or loss item for cash or eliminating a normal built-in gain or loss item.

Treasury regulations are also expected to address the treatment of marketable securities with a value that does not differ substantially from adjusted basis. In appropriate cases it is expected that Treasury regulations will permit such marketable securities to be taken into account in determining whether the threshold has been met. For example, in cases where the business of the taxpayer is the holding of marketable securities (such as the case of entities described in section 382(l)(4)(B)(ii), such marketable securities may be taken into account, provided there is no evidence of manipulation of the marketable securities involved in a manner favorable to the taxpayer.

In applying section 382, it may be to the taxpayer's advantage to meet the 25 percent threshold with respect to built-in gains, or not to meet the threshold with respect to built-in losses. It is expected that receivables and any other cash item, as well as marketable securities, will continue to be excluded from the computation in any case in which there is a variation from the taxpayer's past business practice, or in any other appropriate case with a result that causes the threshold to be met or not met in a manner favorable to the taxpayer; and that prophylactic rules may be utilized for this purpose.[3]

Finally, the bill clarifies that a recognized built-in loss that is disallowed retains its character as a capital loss or ordinary loss and is carried forward under the rules applicable to a loss of that character.

Testing Period

The bill clarifies that the testing period does not begin before the earlier of (1) the first day of the first taxable year from which there is a loss carryforward, or (2) the first day of the taxable year in which the transaction being tested occurs. Thus, where there is a current net operating loss for the taxable year in which an ownership change occurs, the testing period is determined by taking such taxable year into account.

Loss Corporations

The bill clarifies that the definition of a loss corporation includes a corporation entitled to use a pre-change loss (that is, a net operating loss for the taxable year in which an ownership change occurs, as well as a net operating loss carryover to such year). Thus, for example, the definition of a new loss corporation includes a corporation that is entitled to use a net operating loss that was incurred in the taxable year in which an ownership change occurred.

Except as provided in regulations, any entity and any predecessor or successor of such entity is treated as one entity. As an example, if a corporation purchases 100 percent of the stock of an

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[2] Section 10225(b) of the Revenue Act of 1987 provides that these items are included in the term "recognized built-in loss" in the case of ownership changes after December 15, 1987, except for any ownership change pursuant to a binding written contract which was in effect on December 15, 1987, and at all times thereafter before such ownership change.

[3] *See*, *e.g.*, section 382(l)(1)(B), which disregards any changes that might benefit the taxpayer that occur within 2 years prior to the ownership change.

unrelated loss corporation, the loss corporation would become a new loss corporation. If the new loss corporation liquidates in a tax-free transaction pursuant to section 332 (so the new loss corporation's net operating loss carryforwards carry over to the acquiring corporation), the acquiring corporation—as successor—will continue to be treated as a new loss corporation.

The bill also modifies the definition of ownership change by eliminating the references to "old" and "new" loss corporations. This change merely eliminates circularity in the definition of ownership change, and is not intended to have any substantive effect.

Operating Rules Relating to Stock Ownership

The bill clarifies that the constructive ownership rules of section 318 are applied only to "stock" that is taken into account for purposes of section 382. For example, assume a corporation owns both common stock and stock of a type that is not counted in determining whether there has been an ownership change (referred to as "pure preferred") in a holding company. The pure preferred represents 55 percent of the holding company's value. The holding company's only asset consists of 100 percent of the common stock in an operating subsidiary that is a loss corporation. The sale of the pure preferred would not constitute an ownership change because no stock in the loss corporation may be attributed through pure preferred. On the other hand, assume 100 percent of the stock in a loss corporation is transferred in a section 351 exchange, in which the loss corporation's sole shareholder receives pure preferred representing 51 percent of the transferee's value, and an unrelated party receives 100 percent of the transferee's common stock. Here, an ownership change would result with respect to the loss corporation. Similar rules apply where a loss corporation is owned directly or indirectly by a partnership (or other intermediary) that has outstanding ownership interests substantially similar to a pure preferred stock interest.

The bill also clarifies that the rule with respect to options extends beyond options that have been subject to section 318(a)(4).

Bankruptcy Proceedings

The bill clarifies that, for purposes of the 50-percent test, stock of a shareholder is taken into account only to the extent such stock was received in exchange for stock or a qualified creditor's interest that was held immediately before the ownership change. Thus, for example, stock received by a former stockholder for new consideration, such as the provision of funds to the corporation, a guarantee of corporate obligations, or any other consideration, is not taken into account. Similarly, stock purchased from other shareholders in the transaction is not counted. The bill also clarifies that stock received by a qualified creditor is taken into account only to the extent such stock was received in satisfaction of qualified indebtedness.

The bill clarifies the attribute reduction that occurs with respect to amounts that would be cancellation of indebtedness income. The amount of the reduction is 50 percent of the amount that (but for section 108(e)(10)(B)) would have been applied to reduce tax attributes under section 108(b), that is, the excess of the amount of cancelled debt over the fair market value of stock issued in satisfaction of the debt. The bill also clarifies that the amount of the debt outstanding for this purpose does not include previously accrued but unpaid interest that has already been deducted from net operating loss carryforwards under the rule requiring reduction for interest deducted during the three-year period prior to the ownership change.

The bill also clarifies that the denial of a deduction for interest paid or accrued by the old loss corporation during the 3 years preceding the year of the ownership change, on indebtedness which is converted into stock pursuant to a title 11 or similar case, applies not only for purposes of computing any net operating loss deduction but also for purposes of computing any excess credits which may be carried to a post-change year.

In addition, the bill clarifies that if an election to forego the bankruptcy rule is made, the value of the new loss corporation will reflect any increase in value resulting from the surrender of cancellation of creditors' claims in the transaction.

Regarding qualified thrift reorganizations, the bill clarifies that the fair market value of the outstanding stock of the new loss corporation includes the amount of deposits in such corporation immediately after the change. Also, it is clarified that the voting power requirement will not cause a failure of the 20-percent test solely because deposits do not carry adequate voting power.

Effective Dates

The bill clarifies that the provisions of the Act apply to ownership changes occurring after December 31, 1986. For purposes of this transition rule, and for purposes of determining when a new testing

period starts under section 382(i), any equity structure shift pursuant to a plan of reorganization adopted before January 1, 1987 is treated as occurring when such plan was adopted.[4]

By treating equity structure shifts pursuant to plans of reorganization that were adopted before January 1, 1987 as occurring when the plan was adopted, the bill clarifies that no equity structure shift pursuant to a plan adopted after 1986, and no other owner shift involving a 5-percent shareholder occurring after 1986, is protected under the transition provisions, even though such shifts may occur before the completion of a pre-1987 plan of reorganization; i.e., such shifts are not grandfathered by virtue of the pre-1987 plan. If however, an ownership change occurs within the testing period prior to the end of 1986 when any equity structure shift pursuant to a pre-1987 plan is considered together with other pre-1987 owner shifts, that ownership change is grandfathered and a new testing period starts. Any equity structure shift pursuant to a plan adopted after 1986, and any post-1986 owner shift involving a 5-percent shareholder, that occurs before the completion of the pre-1987 plan of reorganization will count for purposes of determining when or whether a later ownership change occurs, under section 382(i).

If, applying the foregoing provisions and the rule in section 382(l)(3) (described below), an ownership change occurs immediately following an equity structure shift pursuant to a post-1986 plan of reorganization, or immediately following any other post-1986 owner shift involving a 5-percent shareholder, the ownership change is subject to the provisions of section 382 as amended by the Act.

The bill clarifies that the May 6, 1986, testing date applies for purposes of determining whether an ownership change occurred after May 5, 1986, and before January 1, 1987. For purposes of determining whether shifts in ownership occurred between May 5, 1986, and January 1, 1987, the rule in section 382(l)(3) for options and similar interests applies. Thus, in the case of such an interest issued on or after May 6, 1986, and before January 1, 1987, the underlying stock could be treated as acquired at the time the interest was issued. For this transition period, however, in addition to the Treasury Department's general regulatory authority under the rule in section 382(l)(3), the Treasury Department may provide for different treatment in the case of an acquisition of an option or similar interest that is not in fact exercised, as appropriate where the effect of treating the underlying stock as if it were acquired would be to cause an ownership change that would start a new testing period (and thus result in relief under the transitional rules). No inference is intended as to how pre-May 6, 1986 options or similar interests would be treated.

The 1954 Code version of section 382(a), relating to nonreorganization transactions, has continuing application to any increase in percentage points of stock ownership to which the provisions of the Act do not apply by reason of any transitional rule—including the rules prescribing measurement of the testing period by reference only to transactions after May 5, 1986, and the rules that disregard ownership changes following or resulting from certain transactions. The 1954 Code version of section 382(b), however, does not apply to any reorganization occurring pursuant to a plan of reorganization adopted after December 31, 1986.

Any regulations that have the effect of treating a group of shareholders as a separate five-percent shareholder by reason of a public offering will not apply to any public offering before January 1, 1989, for the benefit of institutions described in section 591. Further, unless the corporation otherwise elects, an underwriter of any offering of stock of a corporation before September 19, 1986 (January 1, 1989, in the case of an offering for the benefit of an institution described in section 591) will not be treated as acquiring stock in the institution by reason of a firm commitment underwriting, but only to the extent such stock is disposed of no later than 60 days after the initial offering and pursuant to the offering.

Property Transferred in Nonrecognition Transactions

The bill clarifies that the regulatory authority applies to cases where property held on the change date was acquired or is subsequently transferred in a transaction where gain or loss is not recognized in whole or in part. Thus, for example, it is clarified that property transferred in such a nonrecognition transaction prior to the date of the ownership change date is subject to the regulatory authority.

It is expected, as one example, that built-in gain with respect to property transferred in a nonrecognition transaction (including, for example, a tax-free reorganization as well as a section 351

[4] The bill thus clarifies that the transition rule for equity structure shifts pursuant to pre-1987 plans of reorganization is applicable even though such an equity structure shift may also be an owner shift involving a 5-percent shareholder.

contribution to capital) may in appropriate cases be disregarded for purposes of determining the amount of net unrealized built-in gain and for purposes of determining the addition to the section 382 limitation following an ownership change. It is expected that cases where such built-in gain will be disregarded may include transactions in which the value transferred to the corporation would be disregarded under section 382(l)(1) if the transaction had been a contribution to capital.

Certain Related Corporations

The bill clarifies that the regulatory authority is intended to include authority to provide appropriate adjustments to value, built-in gain or loss, and other items so that items are not taken into account more than once or omitted in the case of certain corporations under common ownership.

The bill defines such corporations under common ownership to include any group of corporations described in section 1563(a) (determined by substituting "50 percent" for "80 percent" each place it appears and without regard to section 1563(a)(4)).

RECOGNITION OF GAIN OR LOSS ON LIQUIDATING SALES AND DISTRIBUTIONS OF PROPERTY (*GENERAL UTILITIES*)

Limitations on Recognition of Loss

The bill clarifies that an acquisition of property by a corporation after the date two years before the date the corporation adopts a plan of complete liquidation (rather than merely during the two-year period ending on the date of the adoption of the plan) shall, except as provided in regulations, be treated as acquired as part of a plan a principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation.

The bill also clarifies that the provision denying recognition of loss to the distributing corporation in a section 332 liquidation is intended to apply to a distribution to the corporation meeting the control requirement of section 332 only if the distribution does not result in gain recognition to the distributing corporation, pursuant to section 337(a) or (b)(1). Thus, the provision denies loss recognition on a taxable distribution to minority shareholders in such a liquidation. If the section 332 liquidation is not described in section 337(b)(1) or (2) (for example, in the case of certain liquidations into a tax exempt parent corporation) the special loss disallowance provision of section 336(d)(3) does not apply. Such a transaction would be subject to any other applicable loss disallowance provisions, however.

Election to Treat Certain Stock Sales and Distributions as Asset Transfers

The bill clarifies that Congress did not intend to require the election to be made unilaterally by the selling or distributing corporation. The bill thus provides that, under regulations prescribed by the Secretary, an election may be made to treat the certain sales and distributions of subsidiary stock as asset sales. Compare section 338(h)(10).

Treatment of Distributing Corporation

The bill clarifies that the provision with respect to use in an unrelated trade or business was intended to apply to use in an activity the income from which is subject to tax under section 511(a).[5]

Basis Adjustment in Taxable Section 332 Liquidation

The bill clarifies that if gain is recognized on a distribution of property in a liquidation described in section 332(a) to a corporate distributee meeting the stock ownership requirements of section 332(b), a corresponding increase in the distributee's basis occurs.

Use of Installment Method by Shareholders in Certain Liquidations

The bill clarifies that, as under the law prior to the enactment of the Act, in the case of inventory the corporate sale or exchange must have been not only to one person but to one person in one transaction.

Distributions of Partnership or Interests

The bill generally repeals section 386 of the Code as deadwood in light of the Act's amendments to sections 311, 336 and 337 of the Code. However, the bill restates, in section 311, the provision contained in

[5] A distribution to a charitable trust would not qualify as a distribution to an 80-percent distributee (since only a corporation can qualify as an 80-percent distributee). Accordingly, the bill deletes the reference to section 511(b)(2) in section 377(b)(2).

present-law section 386(d), that the Secretary may by regulations provide that the amount of gain recognized on a nonliquidating distribution of a partnership interest shall be computed without regard to any loss attributable to property contributed to the partnership for the principal purpose of recognizing such loss on the distribution (i.e., thereby reducing the gain otherwise recognized on the distribution and effectively recognizing a loss not permitted in a nonliquidating distribution).[6]

Transactions between Related Taxpayers

The bill clarifies that section 267(a) does not apply either to any loss of the distributee or to any loss of the distributing corporation in the case of a distribution in complete liquidation. Losses may be denied under other provisions of law or judicially created doctrine as under present law.

Distributions of Property to Shareholders

Certain portions of section 301 are repealed as deadwood. Thus, section 301 of the Code is amended to provide that the amount distributed and the basis of property in the hands of a corporate distributee is the fair market value of the property. The holding period of such distributed property in the hands of the distributee begins on the date of the distribution, as under present law, but section 301(e) is not necessary to reach this result and is repealed.[7]

Certain Transfers to Foreign Corporations

The bill clarifies that a transfer of property to a foreign corporation in a transaction that would otherwise qualify as a tax-free reorganization is treated in the same manner as a liquidating transfer of such property to an 80-percent foreign corporate distributee. Thus, in the case of a transfer of property described in section 361(a) or (b) (as amended by the bill) by a U.S. corporation to a foreign corporation, the provisions of section 367(a)(2) and (3) do not apply, and gain is recognized unless regulations provide otherwise. However, subject to such basis adjustments and such other conditions as shall be provided in regulations, this rule does not apply if the U.S. corporate transferor is 80-percent controlled (within the meaning of section 368(c)) by five or fewer domestic corporations. For this purpose, all members of the same affiliated group (within the meaning of section 1504) are treated as one corporation. This provision applies only to transactions occurring after June 10, 1987.

It is expected that regulations will provide this relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. The requirements that five or fewer domestic corporations own at least 80 percent of the U.S. transferor corporation's stock assures that the bulk of the built-in gain will remain subject to U.S. taxing jurisdiction. In addition, it is also expected that regulations will require the U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to U.S. taxing jurisdiction by virtue of a substituted stock basis. This would occur, for example, where 20 percent or less of the U.S. corporate transferor is owned by foreign shareholders who receive substituted basis stock in the transferee corporation, which stock would not be subject to U.S. taxing jurisdiction on disposition.

Gain from Sales or Exchanges of Stock

The bill amends section 1248(f) to conform to the changes under the Act that generally cause gain to be recognized, and earnings and profits to be created, on a liquidating sale or distribution or on a nonliquidating distribution, and that treat liquidating and nonliquidating distributions as sales or exchanges for this purpose. Section 1248(f)(1) under the bill applies only to certain distributions that are still nonrecognition events to the distributing corporation and are not treated as a sale by such corporation to the distributee—that is, distributions that would be tax-free to the recipient under the reorganization provisions of section 361(c) of the Code (as amended by the bill) or under section 355

[6] This provision is not intended to limit the operation of any present-law step-transaction or other doctrines that would disregard such loss. Such doctrines would also apply if a corporation with property on which loss would be disallowed under other Code provisions (such as sections 336(d)(1) or (d)(2)) contributed such property to a partnership to reduce the gain on distribution of the partnership interest and thus indirectly recognize the loss.

[7] This change is made solely as deadwood and is not intended to alter the consequences of a distribution under the consolidated return regulations or any other provision of law or regulation.

of the Code and certain liquidating distributions to an 80-percent distributee. As under present law, section 1248(f)(2) excepts those situations in which the recipients U.S. corporation satisfies the stock ownership requirements of section 1248(f)(2) and is treated as holding stock for the period the stock was held by the distributing corporation.

It is contemplated that the Treasury Department may exercise its regulatory authority under section 1248(f) to provide that, in cases where a distribution that would be tax-free but for section 1248(f)(1) occurs within a controlled group, and section 1248(f)(2) does not otherwise apply, the recipient corporation may be required to take a carryover basis in the stock received (rather than a substituted basis under section 358, for example, in the case of a section 355 or 361 distribution) and section 1248(f)(1) will not apply to such distribution.

The bill repeals sections 1248(f)(3) and 1248(d)(2) as deadwood.

The bill makes certain other related clerical and conforming amendments.

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Distributions by S Corporations

The bill provides that the distribution by an S corporation of an installment obligation with respect to which the shareholder is entitled to report the shareholder's stock gain on the installment method (by reason of section 453(h)) will not be treated as a disposition of the obligation. This rule will allow the shareholder to report the gain over the same period of years as if the amendments made by the 1986 Act had not been enacted. This special rule does not apply for purposes of determining the corporation's tax liability under subchapter S. In addition, the character of the shareholder's gain shall be determined as if the corporate level gain had been passed through to the shareholder under section 1366.

The special distribution rules provided in Code section 1363(d) and (e) of the Code are repealed as deadwood. Thus, for example, it is clarified that, pursuant to section 1371 of the Code, the provisions of subchapter C of the Code apply to determine the recognition of gain and loss in the case of a distribution by an S corporation.

Regulatory Authority to Prevent Circumvention of Provisions

The bill clarifies that the regulatory authority to prevent circumvention of the provisions of the Act extend to all the amendments made by subtitle D of Title VI of the Act. The bill also clarifies in connection with the built-in gain provisions of the Act that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out those provisions, including provisions dealing with the use of such pass-through entities, other than S corporations, as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this includes rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT or to a tax-exempt entity[8] in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.

It is expected that Treasury shall also prevent the avoidance of the section through contributions of property with built-in loss to a corporation before it becomes an S corporation.

It is also expected that the Treasury Department will prevent the manipulation of accounting methods or other provisions that may have the result of deferring gain recognition beyond the 10 year recognition period—for example, in the case of a C corporation with appreciated FIFO inventory that converts to S status and elects the LIFO method of accounting.

Section 704(c) of the Code generally requires that gain attributable to appreciated property contributed to a partnership by a partner be allocated to that partner; it is expected that this rule would generally prevent the use of a partnership to avoid the purposes of the amendments made by subtitle D of Title VI of the Act (for example, by attempting to shift the tax on C corporation appreciation to another party or to a non-C corporation regime). However, if and to the extent that partners might utilize allocation rules or other partnership provisions (including the so-called "ceiling rule" contained in the regulations under section 704(c)) to defer the recognition of built-in gain to a corporate partner by shifting the incidence of current gain recognition, it is intended that the Treasury Department may exercise its authority to prevent such results.

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[8] The Act generally requires recognition of gain if a C corporation transfers appreciated assets to a tax exempt entity in a section 332 liquidation. *See* Code section 337(b)(2).

Transition Provisions

Built-in gains of S corporations. The bill clarifies that, for purposes of the transition provisions, if a corporation was a C corporation at any time prior to December 31, 1986, any "S" status of such corporation prior to its "C" corporation status is disregarded. Thus, the bill provides that (subject to the special small-corporation transition rules of the Act) the built-in gains provisions apply to taxable years beginning after December 31, 1986, in cases where the return for the taxable year is filed pursuant to an S election made after December 31, 1986.

The bill clarifies that a 34-percent tax rate applies to capital gain that is subject to prior law section 1374 in taxable years beginning after December 31, 1986.

General transition rule based on pre-August 1, 1986 action. The bill clarifies that the transition rule applies if more than 50 percent (rather than 50 percent or more) of the voting stock is acquired pursuant to the binding written contract.

A clarification is made regarding the exception for a qualified stock purchase pursuant to a binding contract in effect before August 1, 1986. For purposes of this exception, a modification of a contract for the purchase of stock in more than one corporation that arises because of third party rights in the stock to be acquired (such as a right of first refusal), or because of the rules and rulings of government agencies or courts, is not intended to cause a contract to be deemed nonbinding, so long as the stock acquired was a part of the original contract. This clarification is not intended to create any inference regarding the meaning of binding contract in other contexts.

Transitional rules for certain small corporations. The bill provides that a qualified corporation eligible for the special delayed effect dates does not recognize gain on a distribution of installment obligations that are received in exchange for long-term capital gain property (including section 1231 property the disposition of which would produce long-term capital gain) where the distribution of such obligations would not have caused corporate level recognition under sections 337 and 453B(d)(2) as in effect prior to the Act. However, distributions of such installment obligations received in exchange for ordinary income property or short-term capital gain property do require the recognition of corporate level gain.

It is intended that a taxpayer that purchases the stock of a qualified corporation in a qualified stock purchase prior to January 1, 1989, is entitled to apply prior-law rules (modified as in the case of actual liquidations) with respect to an election under section 338, even though in the hands of the acquiring corporation the qualified corporation no longer satisfies the stock holding period requirements and may not satisfy the size or shareholder requirements due to the size or shareholders of the acquiring corporation.

The bill clarifies that, although the Act repealed section 333 of the Code, in the case of a liquidating distribution to which section 333 of prior law would apply, a shareholder of a qualified corporation electing such treatment is entitled to apply section 333 without any phase-out of shareholder level relief under the Act. However, an increase in shareholder-level gain could result from an increase in corporate earnings and profits resulting from application of the corporate-level phase-out of relief.

The bill clarifies that for distributions before January 1, 1989, qualifying corporations continue to be eligible for relief under prior-law rules relating to nonliquidating distributions with respect to qualified stock, (prior law sec. 311(d)(2)), without regard to whether the corporation liquidates before January 1, 1989. However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

The bill provides that a corporation is not a qualified corporation unless more than 50 percent (by value) of the stock of such corporation is owned (on August 1, 1986 and at all times thereafter before the corporation is completely liquidated) by the same 10 or fewer qualified persons who at all times during the 5-year period ending on the date of the adoption of the plan of liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) owned (or were treated as owning under the attribution rules) more than 50 percent (by value) of the stock of such corporation. This change to the statutory language of the Act, incorporating a holding period requirement, does not apply to nonliquidating distributions before March 31, 1988 (the date of introduction of the bill), to liquidating sales or distributions pursuant to a plan of liquidation adopted before March 31, 1988, or to deemed liquidating sales pursuant to an election under section 338 where the acquisition date under section 338 occurs before March 31, 1988. Also, for purposes of applying section 1374 in the case of a qualified corporation, the provision does not apply if the S election was filed before March 31, 1988.

Where stock passes to an estate, the holding period of the estate includes that of the decedent. Also, the "look-through" attribution rules that apply under this provision do not apply in the case of trusts qualifying under section 1361(c)(2)(ii) or (iii), just as they do not apply under the Act in the case of estates. Thus, stock held by such entities, like stock held by an estate, is to be treated as held by a single qualified person, so that the 10-shareholder test will not cease to be satisfied merely because a decedent's stock passes to such a trust. (In the case of other trusts holding stock, the "look-through" attribution rules apply to determine whether more than 10 qualified persons ultimately own the stock.)

The bill also clarifies that the holding period of a decedent's estate (or a section 1361(c)(2)(A)(ii) or (iii) trust) is tacked with that of any beneficiary, as well as with that of the decedent, for purposes of determining the holding period. However, except in the case of beneficiaries who are treated as being "one person" with the decedent, once stock has been distributed to beneficiaries, the 10-shareholder requirement might fail to be satisfied due to an increase in the number of shareholders. Property acquired by reason of the death of an individual is treated as owned at all times during which the property was treated as owned (in addition to actually owned) by the decedent (as one example, property treated as owned by the decedent under the grantor trust rules, as well as property treated as owned by the decedent pursuant to attribution rules, would have a tacked holding period for this purpose).

In the case of indirect ownership through an entity, the rules described above are the only rules that apply to determine ownership and holding period. Thus, it is not intended that holding periods could otherwise be "bootstrapped" through analogy to or application of any provision of section 1223. For example, if a partnership owns all the stock of a corporation, a new partner who contributes other property to the partnership in exchange for a partnership interest is deemed under section 1223 to have a holding period in the partnership interest that includes such person's holding period for the property contributed. However, such a person would not be deemed thereby to have owned stock in the corporation that the partnership owned for any period prior to the time the person became a partner. In such cases, under the attribution and other holding period rules of the transitional provision a qualified person's holding period for the underlying stock is the lesser of (1) the period during which the entity held the stock in the qualified corporation, or (2) the period during which the qualified person held the interest in the entity. In other situations, the basic attribution and holding period rules of the transitional rule provision may provide a different result.[9]

The bill clarifies that the rule that all members of a controlled group of corporations (as defined in section 267(f)(1)) are treated as a single corporation applies solely for purposes of determining whether the corporation meets the size requirements for relief. Thus, it is clarified that it is not necessary for all members of a group that, in the aggregate, meets the size requirements for a qualified corporation, to liquidate before January 1, 1989, in order for the liquidation of one member of the group to qualify for relief. It is not intended that an S corporation be included as a member of the group unless such corporation was a C corporation for its taxable year including August 1, 1986 or was an S corporation that was not described in section 1374(c)(1) or (2) of prior law for such taxable year.

The bill also provides a rule to prevent the use of qualified corporations as conduits for the sale of assets by corporations that are not qualified. It is expressly provided that the transition rules do not apply where a principal purpose of a carryover basis transfer of an asset to a qualified corporation is to secure the benefits of the special transition rules. This provision is not intended to limit the application of the step transaction doctrine or other doctrines that would prevent the use of the transition rules. It is expected that a similar step transaction approach would be applied in the case of any transfer of assets to any corporation that qualified for transition under any of the other provisions of the Act, if a principal purpose of the transfer was to secure the benefit of transition for an otherwise non-qualified transaction.

The bill makes certain other clerical and conforming changes.

Effective Dates

In general, the provisions of the bill are effective as of January 1, 1987.

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[9] For example, if a qualified person held stock of a corporation and subsequently contributed that stock to a partnership, the person's holding period would include the entire period of stock was held, directly or indirectly. The bill does not make any statutory change with respect to section 1223 since section 1223 does not by its terms operate to extend attribution periods, as explained above.

JOINT COMMITTEE EXPLANATION OF SENATE CONSENSUS AMENDMENT

Outbound liquidations. Provide that the technical correction relating to transfers of property to a foreign corporation that would otherwise qualify as a tax-free reorganization would apply only to transactions occurring after June 21, 1988, except that such technical correction would not apply to reorganizations for which a plan of reorganization had been adopted before June 22, 1988.

Mirror subsidiary transition rule. Clarify that, for purposes of the exception from the effective date provision concerning mirror subsidiary transactions in cases where 80 percent of the stock of the distributing corporation is acquired by the distributee, the ownership of distributees which are members of the same affiliated group may be aggregated in certain cases.

Section 384 and common control exception. Provide that if the gain corporation, the loss corporation or both were not in existence throughout the five year period, the exception will be applied by substituting the shorter of the periods during which the gain corporation, the loss corporation, or both were in existence.

Section 384 and treatment of affiliated corporations. Clarify in legislative history that not only post-affiliation gains or losses, but also pre-affiliation gains or losses which were not limited under section 384, are not subject to the limitations of section 384 upon the merger of members of the same affiliated group.

* * * *

Special rule relating to 1976 Act net operating loss limitations. Clarify that warrants would not be treated as stock under section 382 of the 1976 Act.

HOUSE COMMITTEE REPORT

Tax Imposed on Certain Built-In Gains of S Corporations

The bill modifies the operation of the built-in gains tax. The bill retains the net income limitation of the Act by providing that a net recognized built-in gain for a year will not be taxed to the extent the corporation would not otherwise have taxable income for the year if it were a C corporation (determined in accordance with section 1375(b)(1)(B)). Under the bill, therefore, recognized built-in gain in any post-conversion year is reduced for purposes of the built-in gains tax by any recognized built-in loss for that year, and also by any other post-conversion losses for that year.

Although the committee believes it is appropriate not to impose the built-in gains tax in a year in which the taxpayer experiences losses, the committee also believes it is appropriate to reduce the potential for taxpayers to manipulate the timing of post-conversion losses in a manner that might entirely avoid the built-in gains tax on the net unrealized built-in gain of the former C corporation. Accordingly, the bill provides that any net recognized built-in gain that is not subject of the built-in gains tax due to the net income limitation will be carried forward.

Thus, an amount equal to any net recognized built-in gain that is not subject to the built-in gains tax because of the net income limitation will be carried forward and will be subject to the built-in gains tax to the extent the corporation subsequently has other taxable income (that is not already otherwise subject to the built-in gains tax) for any taxable year within the 10 year recognition period. This provision of the bill applies only in the case of subchapter S elections made on or after March 31, 1988.

The provision is illustrated by the following example: Corporation A elects S status on March 31, 1988. The corporation has two assets, one with a value of $200 and an adjusted basis of $0 and the other with a value of $0 and an adjusted basis of $100. It has no other items of built-in gain or loss. The corporation thus has a net unrealized built-in gain of $100. In its first taxable year for which it is an S corporation, the corporation sells both assets for their fair market value and has a net recognized built-in gain of $100. It also has an additional $100 loss from other post-conversion activities. The corporation is not subject to any built-in gains tax in that year because its net recognized built-in gain ($100) exceeds its net income determined in accordance with section 1375(b)(1)(B) ($0). In its next taxable year, the corporation has $200 of taxable income. $100 is subject to the built-in gains tax in that year, because of the carryforward of the $100 of net unrecognized built-in gain that had been untaxed due to the net income limitation.

The bill clarifies that the built-in gain provision applies not only when a C corporation converts to S status but also in any case in which an S corporation acquires an asset and the basis of such asset in the hands of the S corporation is determined (in whole or in part) by reference to the basis of such asset (or any other property) in the hands of the C corporation. In such cases, each acquisition of assets from a C corporation is subject to a separate determination of the amount of net built-in gain,

and is subject to the provision for a separate 10-year recognition period. The bill clarifies that the Treasury Department has authority to prescribe regulations providing for the appropriate treatment of successor corporations—for example, in situations in which an S corporation engages in a transaction that results in carryover basis of assets to a successor corporation pursuant to subchapter C of the Code.

The bill clarifies that, for purposes of this built-in gains tax under section 1374, any item of income which is properly taken into account for any taxable year in the recognition period but which is attributable to periods before the first taxable year for which the corporation was an S corporation is treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Thus, the term "disposition of any asset" includes not only sales or exchanges but other income recognition events that effectively dispose of or relinquish a taxpayer's right to claim or receive income. For example, the term "disposition of any asset" for purposes of this provision also includes the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

Similarly, the bill clarifies that amounts that are allowable as a deduction during the recognition period but that are attributable to periods before the first S corporation taxable year are thus treated as recognized built-in losses in the year of the deduction.

As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such preconversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.

The bill clarifies that capital loss carryforwards may also be used to offset recognized built-in gains.

Finally, the bill makes certain clerical and conforming changes.

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CONFERENCE COMMITTEE REPORT

Senate Amendment

Corporate. The Senate amendment is the same as the House bill, except—

(1) the Senate amendment clarifies the treatment of warrants under a transitional rule relating to the 1976 Act version of section 382;

(2) the Senate amendment provides that the provision relating to outbound transfers applies to transfers on or after June 21, 1988, other than reorganizations for which a plan of reorganization had been adopted before June 21, 1988; the House bill applies to transfers on or after June 21, 1988;

(3) the House bill limits the net built-in gain subject to tax in the case of an S corporation to the corporation's taxable income with a carryforward of any net built-in gain in excess of taxable income for the year;

* * * *

Conference Agreement

The conference agreement follows the Senate amendment; except the agreement...does follow the House version of the S corporation tax on net built in gains.

Section 621(f)(5) of the Tax Reform Act of 1986 provides relief from the amendments made by that Act to sections 382 and 383 of the Code in the case of certain transactions involving a title 11 or similar case if a petition in such case was filed with the court before August 14, 1986. The relevant provisions of section 368 that define a title 11 or similar case provide that in certain proceedings involving specified financial institutions where the relevant proceeding is before a Federal or State agency, the agency shall be treated as a court. The conferees clarify that for purposes of the transaction rule contained in section 621(f)(5), the petition shall be considered filed with the court in the case of such agency proceedings no later than the time the relevant agency action has occurred. As one example, in the case of an insolvent thrift institution subject to regulation by the Federal Savings and Loan Insurance corporation ("FSLIC"), a petition will be deemed to have been filed no later than the date such agency assumes control over such institution through the appointment of a receiver. No inference is intended that other action might not also constitute the filing of a petition in appro-

priate cases, consistent with the relief granted to transactions covered by the relevant provisions of section 368.

The conference agreement clarifies that the tax on transfers of residual interests of REMICs to disqualified organizations and the tax on pass-through entities and nominees are treated as excise taxes for administrative purposes, except that the Tax Court has jurisdiction over deficiencies of these taxes.

The conferees clarify the definition of a "qualified corporation" under the transition rules of section 633(d)(5) of the Tax Reform Act of 1986 in the case of a corporation which adopted a plan of liquidation prior to March 31, 1988, and is completely liquidated prior to January 1, 1989. If, on August 1, 1986, and at all times thereafter before such liquidation, more than 50 percent, by value, of the corporation's stock was owned by 10 or fewer qualified persons, such corporation would come within the definition of "qualified corporation" under section 633(d)(5) of the Tax Reform Act of 1986 regardless of how long any such shareholders have held their stock and regardless of whether or not such shareholders were the same throughout the applicable period.

In addition, the conferees clarify the definition of a "qualified group" under section 633(d) of the Tax Reform Act of 1986, as amended by this Act, in connection with the following case. One hundred percent of the shares of a corporation are owned by two shareholders until mid-1987, each holding 50 percent of the issued and outstanding shares. These shareholders had owned their shares for more than five years. Subsequently, after mid-1987, 100 percent of the issued and outstanding shares of the corporation were owned by one of the two original shareholders. This shareholder had owned his shares for more than five years. These shareholders would come within the definition of "qualified group" under section 633(d) of the Tax Reform Act of 1986. However, it may not be appropriate to extend this treatment to situations where an insubstantial shareholder acquires more than 50 percent of the stock of a corporation.

Finally, the conference agreement clarifies the provision in the Act relating to the treatment of accounts receivable for purposes of the 25-percent built-in gain or loss rule in connection with the limitations on net operating losses. Under the Tax Reform Act of 1986, for purposes of calculating the 25-percent threshold test, assets are to be reduced by cash and cash items, which include accounts receivable. The Act provides the Treasury authority to change this rule by regulation. The conferees expect that such regulations would be prospective in effect and thus would not apply to ownership changes in completed transactions and in transactions as to which there is a binding contract, including a binding purchase offer, before the date of issuance of such regulations.

ACT SEC. 4012 AND IRC § 382: FINANCIAL INSTITUTIONS

Conference Committee Report

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Financially troubled financial institutions: Reorganizations, NOLs, and FSLIC/FDIC Assistance Payments. The following three rules applying to financially troubled thrift institutions are scheduled to expire December 31, 1988.

(1) Gross income of a domestic savings and loan association does not include assistance payments from the Federal Savings and Loan Insurance Corporation ("FSLIC") and no basis reduction is required on account of such payments;

(2) Certain FSLIC-assisted acquisitions of financially troubled thrift institutions may qualify as tax-free reorganizations, without regard to the continuity of interest requirement; and

(3) Special rules apply to the carryforward of net operating losses, built-in losses, and excess credits of a thrift institution that has certain ownership changes.

Senate Amendment

Under the Senate amendment, the three present law rules for financially troubled thrift institutions are extended for six months, through June 30, 1989, with a modification. Under the modification, net operating losses exist at the time of the regulatory assistance, interest expense, and loan portfolio built-in losses are reduced by an amount equal to 50 percent of the tax-free FSLIC assistance payments. In the case of taxable asset acquisitions, there is no reduction in deductions on account of any payments made at the time of the acquisition to the person acquiring such assets to make up the difference between the fair market value of the assets transferred and the liabilities assumed.

The above rules are also applied during the six-month period to financially troubled banks and to payments made to such banks by the Federal Deposit Insurance Corporation ("FDIC").

The provisions are effective as follows:

(1) The extension of the tax-free treatment of assistance payments with the 50-percent cutback, and the application of these rules to banks, apply to assistance payments made pursuant to acquisitions occurring after December 31, 1988 and before July 1, 1989, and to other assistance payments made during such period unless pursuant to an acquisition occurring on or before December 31, 1988.

(2) The extension of tax-free reorganization rules, and the application of these rules to banks, apply to acquisitions after December 31, 1988 and before July 1, 1989.

(3) The extension of the carryforward rules, and the application of these rules to banks, apply to ownership changes occurring after December 31, 1988 and before July 1, 1989.

Conference Agreement

The conference agreement follows the Senate bill with modifications.

Tax attribute reduction: definition of recognized built-in portfolio losses. The conference agreement modifies the definition of the recognized built-in losses that are subject to the 50-percent cutback. Such losses include all recognized built-in portfolio losses, without regard to whether or not the amount of net unrealized built-in portfolio losses exceeds the 25-percent threshold of section 382(h)(3)(B) of the Code.

Recognized built-in portfolio losses include built-in losses on property described in section 595(a) of the Code, and losses on marketable securities as defined in section 453(f)(2) of the Code, as well as loan portfolio built-in losses.

Certain taxable asset acquisitions: 50-percent cutback and basis recovery provisions. The conference agreement modifies the application of the 50-percent cutback in the case of taxable asset acquisitions. In the case of any acquisition of assets of any applicable financial institution to which section 381 does not apply, the 50-percent cutback does not apply with respect to assistance payments made at the time of the acquisition to the person acquiring such assets that are excludable under section 597(a) of the Code. For purposes of this subsection, payments made at the time of the acquisition shall only include cash payments. Payments made after the acquisition pursuant to notes or other rights to receive future payments (including income maintenance payments with respect to loans, payments under guarantees against loss on certain assets, or any other rights) shall be subject to the 50-percent cutback to the extent they exceed the cumulative recovery (as prescribed by the Treasury Department) of the basis that is properly allocated to such rights.

It is expected that basis shall be properly allocated to such rights under this provision and that such basis allocation shall reflect the full present value, at the time of the acquisition, of the amounts that may be received pursuant to the notes or other rights, and shall include the value of any guarantee against further declines in value with respect to guaranteed assets that may occur after the acquisition of such assets.

It is expected that the Treasury Department shall not permit the basis with respect to such rights to be recovered over a period shorter than the actual period of the note, guarantee, or other right (including extensions, if any). It is also expected that the basis recovery method prescribed by the Treasury Department may take into account yield-to-maturity principles, so that a smaller amount of basis shall generally be recovered in the earlier years than in the later years; and payments made earlier than the time reflected in the present value basis computation would be subject to the 50-percent cutback.

No deduction for tax purposes shall be allowed for any basis recovery with respect to such rights unless and until such rights finally expire. At that time, a deduction shall be allowed for the excess, if any, of the amount of basis properly allocated to such rights over the amount of payments actually received pursuant to such rights.

Repayments of assistance payments for which a prior attribute cutback occurred. The conference agreement provides that if a taxpayer repays an amount and the 50-percent cutback applied to that taxpayer with respect to such amount in a preceding taxable year, there shall be allowed as a deduction for the taxable year of repayment an amount equal to the reduction in tax attributes that was attributable to the amount repaid.

Application of section 265. Under the conference agreement, no provision of section 265 of the Code shall deny a deduction by reason of such deduction being allocable to amounts excluded from gross income under section 597 of the Code.

General effective dates of extensions and related attribute cutback. The conference agreement modifies the effective dates of the basic extension of the three special present law provisions for financially troubled thrift institutions, and for the related attribute cutback rules (including the special taxable asset acquisition provisions), as follows:

(1) The extension of the tax-free treatment of assistance payments, and the cutback of attributes with respect to such tax-free payments, apply to assistance payments made pursuant to acquisitions occurring after December 31, 1988 and before January 1, 1990, and to other assistance payments made during such period unless pursuant to an acquisition occurring on or before December 31, 1988.

(2) The extension of the tax-free reorganization rules applies to acquisitions after December 31, 1988 and before January 1, 1990.

(3) The extension of the carryforward rules applies to ownership changes occurring after December 31, 1988 and before January 1, 1990.

Application to banks. The conference agreement clarifies that the provisions with respect to assistance payments made to financially troubled banks by the Federal Deposit Insurance Corporation ("FDIC") extend to payments made pursuant to 12 U.S.C. sections 1823(c)(1) and (2), as well as to payments made pursuant to 12 U.S.C. section 1821(f).

The conference agreement modifies the effective date of the provisions with respect to financially troubled banks and payments made to such banks by the FDIC. The application of the tax-free treatment of assistance payments and the attribute cutback rules in these cases apply to assistance payments made pursuant to acquisitions occurring after the date of enactment of the provision and before January 1, 1990, and to other assistance payments made during such period unless pursuant to an acquisition occurring on or before the date of enactment.

The extension of the tax-free reorganization rules to banks applies to acquisitions after the date of enactment and before January 1, 1990.

The extension of the carryforward rules to banks applies to ownership changes occurring after the date of enactment and before January 1, 1990.

Application to certain other entities. The conference agreement also extends the provisions that apply to banks and FDIC assistance payments to entities that would be domestic building and loan associations under section 7701(a)(19) but for the fact that they do not satisfy the 60-percent asset test prescribed in section 7701(a)(19)(C), and to FSLIC assistance payments to such entities. The effective dates of the provisions with respect to such entities, including the attribute cutback rule, are the same as the effective dates of the provisions with respect to banks.

ACT SEC. 1004 AND IRC § 108(G): TREATMENT OF DISCHARGE OF INDEBTEDNESS INCOME OF CERTAIN FARMERS

House Committee Report

The bill clarifies that, for purposes of determining whether a taxpayer's indebtedness is qualified farm indebtedness, the gross receipts test is applied by dividing the taxpayer's aggregate gross receipts from farming for the three-taxable-year period preceding the taxable year of the discharge by the taxpayer's aggregate gross receipts from all sources for that period. In addition, the term "qualified person" is modified to include a Federal, State, or local government or agency or instrumentality thereof.

The bill provides that, after reducing tax attributes on the order prescribed for insolvent taxpayers, amounts excluded from income under the qualified farm indebtedness provision may be applied to reduce basis in assets used or held for use in a trade or business or for the production of income (i.e., in "qualified property"). Basis reduction occurs first with respect to depreciable property, then with respect to land used in the business of farming, and then with respect to other qualified property.

The amount excluded under this provision may not exceed the taxpayer's total available attributes and basis in qualified property. Accordingly, to the extent there is unabsorbed discharge of indebtedness income after the taxpayer has reduced tax attributes and basis in qualified property, income will be recognized.

Conference Agreement

The conference agreement follows the House bill.***

ACT SEC. 1018(D)(5) AND IRC § 361: EARNINGS AND PROFITS

Senate Committee Report

Treatment of reorganization exchange.—The bill restores the provisions of section 361, relating to the nonrecognition treatment of an exchange pursuant to a plan of reorganization, as in effect prior to the amendments made by the 1986 Act. Thus, as under prior law, gain or loss will generally not be recognized to a corporation which exchanges property, in pursuance of the plan of reorganization, for stock

and securities in another corporation a party to the reorganization. However, as under prior law, gain will be recognized to the extent the corporation receives property other than such stock or securities and does not distribute the other property pursuant to the plan of reorganization.[10]

The bill amends prior law by providing that transfers of property to creditors in satisfaction of the corporation's indebtedness in connection with the reorganization are treated as distributions pursuant to the plan of reorganization for this purpose.[11] The Secretary of the Treasury may prescribe regulations necessary to prevent tax avoidance by reason of this provision. This amendment is not intended to change in any way the definition of a reorganization within the meaning of section 368.

Treatment of distributions in reorganizations.—The bill also conforms the treatment of distributions of property by a corporation to its shareholders in pursuance of a plan of reorganization to the treatment of nonliquidating distributions (under section 311). Under the bill, the distributing corporation generally will recognize gain, but not loss, or the distribution of property in pursuance of the plan of reorganization. However, no gain will be recognized on the distribution of "qualified property". For this purpose, qualified property means (1) stock (or rights to acquire stock) in, or the obligation of, the distributing corporation and (2) stock (or rights to acquire stock) in, or the obligation of, another corporation which is a party to the reorganization and which were received by the distributing corporation in the exchange.[12] The bill also provides that the transfer of qualified property by a corporation to its creditors in satisfaction of indebtedness is treated as distribution pursuant to the plan of reorganization.[13]

Basis.—The bill clarifies that the basis of property received in an exchange to which section 361 applies, other than stock or securities in another corporation a party to the reorganization, is the fair market value of the property at the time of the transaction (pursuant to section 358(a)(2)). Thus the distributing corporation will recognize only post-acquisition gain on any taxable disposition of such property received pursuant to the plan of reorganization. Of course, the other corporation will recognize gain or loss on the transfer of its property under the usual tax principles governing the recognition of gain or loss.

Treatment of section 355 distributions, etc.—Finally, the bill provides that the rules of section 311 shall apply to the distribution or property in a section 355 transaction which is not in pursuance of a plan of reorganization. Thus, gain (but not loss) will be recognized on the distribution of property other than the stock or securities in the controlled corporation in a transfer to which section 355 (or so much of section 356 as relates to section 355) applies. For this purpose, the gain recognition provisions of section 311(b) will not apply to the distribution of securities notwithstanding that the recipient may be taxed by reason of the excess principal amount rule of section 355(a)(3)(A), but the gain recognition rule will apply to stock which is not permitted to be received tax-free under section 355.

Effective for transfers on or after June 21, 1988, a similar rule applies to the transfer of property to a shareholder by a corporation in an exchange to which section 351(b) applies to the shareholder. Thus, gain (but not loss) will be recognized to the controlled corporation on the transfer of property to its shareholder as if the transfer were a distribution to which section 311(b). No inference is intended as to the tax treatment of such a transfer under present law.

* * * *

Conference Agreement

The conference agreement follows the Senate amendment.

[10] This could occur, for example, where liabilities are assumed in a transaction to which section 357(b) or (c) applies.

[11] This overrules the holding in *Minnesota Tea Company v. Helvering*, 302 U.S. 609 (1938).

[12] For analysis that acquiring corporation voting stock held by the acquired corporation in a Type C reorganization is transferred to the acquiring corporation in exchange for the same stock, *see* Rev. Rul. 78-47, 1978-1 C.B. 113.

[13] These amendments are not intended to affect the treatment of any income from the discharge of indebtedness arising in connection with a corporate reorganization.

APPENDIX G

Tax Consequences of Plan—Revco

One item that is included in many of the disclosure statements that are required in chapter 11 reorganization cases is the tax consequences of the plan. The discussion of the tax consequences of the plan generally explains the tax consequences to the debtor, stockholders, and creditors. A discussion of the tax consequences of Revco's reorganization plan that was included in Revco's disclosure statement is presented in this appendix.

TAX CONSEQUENCES OF REVCO'S PLAN

VIII. Tax Consequences

The following discussion summarizes certain federal income tax consequences of the Revco Plan to creditors, stockholders, and the Revco Debtors, based on the Internal Revenue Code of 1986, as amended (the "Tax Code"), the Treasury Regulations promulgated thereunder, judicial authorities, and current administrative rulings and practice. The tax consequences to creditors may vary based on the individual circumstances of each creditor. Certain types of investors (including foreigners, life insurance companies, and tax-exempt organizations) may be subject to special rules not addressed here. The federal income tax consequences to any particular creditor may be affected by matters not discussed below. Each creditor should consult with his own tax advisor regarding the federal, state and local tax consequences of the Revco Plan.

The tax consequences of certain aspects of the Revco Plan are uncertain because of the lack of applicable legal precedent. They may be subject to administrative or judicial interpretations that differ from the discussion below. No opinion of counsel has been obtained by the Revco Debtors with respect thereto. The following discussion does not include state and local tax considerations that may be applicable to the Revco Debtors and creditors.

A. FEDERAL INCOME TAX CONSEQUENCES TO THE REVCO DEBTORS

1. Net Operating Losses.

For federal income tax purposes, the Revco Debtors have substantial net operating loss carryovers ("NOLs"). The extent to which the NOLs allocable to a particular Revco Debtor will be available to offset future income of that Revco Debtor will depend upon certain limitations under the Tax Code discussed below. The manner in which such limitations should be applied to the Revco Debtors is subject to substantial uncertainty. As discussed below, if the IRS adopted an interpretation of the applicable limitations different than the one applied by the Revco Debtors, all the NOLs could be eliminated. As of June 1, 1991 regular NOLs reportable on the Revco Debtors' federal income tax returns are approximately $335 million. Although the Revco Debtors believe their calculation of the NOLs is accurate, the IRS may disallow all or part of the NOLs on audit.

As discussed below, the NOLs will be reduced substantially as a result of the discharge of various liabilities pursuant to the Revco Plan and it is anticipated that the remaining NOLs will be subject to an annual limitation under section 382 of the Tax Code. Furthermore, there can be no assurance that the NOLs will not become subject to further limitation in the future as a result of transactions that may occur, such as changes in the direct and indirect ownership of the Revco Debtors.

2. Future Utilization of NOLs and Unrealized Losses.

Generally, section 382 of the Tax Code imposes a limitation on the utilization of NOLs and unrealized losses if there has been a change in ownership, over a statutorily prescribed period of time, of more than 50 percent of the stock in a corporation (an "ownership change"). The Revco

Debtors will undergo an ownership change as a result of the Revco Plan and the Anac Plan. Under the limitation, the amount of the Revco Debtors' annual taxable income that can be offset by NOLs and unrealized losses attributable to periods before the ownership change cannot exceed the product of the fair market value of the stock of the Reorganized Companies at the time of the ownership change and a long-term tax-exempt bond rate prescribed by the IRS. The Revco Debtors' calculation of the section 382 limitation is subject to review and possible adjustment by the IRS.

Section 382(I)(5) of the Tax Code provides an exception that allows corporations that undergo an ownership change in a chapter 11 plan of reorganization, such as the Revco Plan, to avoid the general section 382 limitation on their NOLs. However, in order to qualify for the section 382(I)(5) exception, the shareholders and "qualified creditors" of the corporation must own 50 percent or more of the value and voting power of the reorganized company after the ownership change. It is uncertain whether the Revco Debtors could satisfy this requirement. In any event, the NOLs and other tax attributes must be reduced pursuant to rules under section 382(I)(5) by: (a) any deduction for interest claimed by the loss corporation with respect to any indebtedness converted into stock for the three-year period preceding the taxable year of the ownership change plus the portion of the year of the ownership change prior to confirmation of the plan, and (b) 50 percent of the excess of discharged debt over the value of certain stock transferred to creditors.

For a corporation that fails to qualify for or elects out of the section 382(I)(5) exception, section 382(I)(6) of the Tax Code provides that the limitation under section 382 will reflect the increase (if any) in the value of the corporation resulting from any surrender or cancellation of claims by the creditors in a transaction in which stock is issued in exchange for debt. The Revco Debtors intend to take the position that the fair market value that would be utilized under section 382(I)(6) will equal the value of the New Common Stock distributed pursuant to the Revco Plan (including such stock distributed to Zell/Chilmark pursuant to the Merger Agreement).

Even in the event section 382(I)(5) were to apply to the Revco Debtors, the Revco Debtors currently intend to elect not to have the section 382(I)(5) exception apply. If the Revco Debtors so elect, section 328(I)(6) will apply to the Revco Debtors and the future utilization of the Revco Debtors' NOLs will be limited under section 382.

3. Discharge of Indebtedness.

A. General Rules.

Under the Tax Code, a taxpayer must generally include in gross income the amount of any indebtedness discharged during the taxable year, except to the extent payment of the indebtedness would have given rise to a deduction. If a debtor issues a debt instrument in satisfaction of indebtedness, the debtor is treated as having satisfied the indebtedness with an amount of money equal to the issue price (as defined in section 1273(b) of the Tax Code) of the debt instrument.

Under section 108 of the Tax Code, when the discharge of indebtedness is pursuant to a plan approved by the court in a case under chapter 11 of the Bankruptcy Code, the amount of discharged indebtedness otherwise required to be included in income is instead applied to reduce certain tax attributes of the taxpayer, in the following order: NOLs, certain credit carryovers, capital loss carryovers, the basis of the taxpayer's property, and foreign tax credit carryovers. Furthermore, a judicially developed rule, now reflected in section 108(e)(10) of the Tax Code, provides that a qualifying exchange of stock for debt by a corporation in a chapter 11 case does not result in a discharge of indebtedness.

Under the Revco Plan, some creditors will not have their claims paid in full, resulting in a discharge of indebtedness of the Revco Debtors (except to the extent the stock-for-debt exception applies). If a discharge of indebtedness occurs, the discharged Revco Debtors' tax attributes will be reduced by the difference between the consideration received by the creditors and the amount of the discharged indebtedness, unless the claims discharged would have given rise to a deduction to the Revco Debtors if they had been paid in full by the Revco Debtors.

Under the Revco Plan, all cross-corporate guarantees will be eliminated. The Revco Debtors believe that elimination of the guarantees will not result in a discharge of indebtedness to the guarantors, but the IRS might take a different position.

The Revco Debtors anticipate that certain intercompany claims will be contributed to capital, rather than repaid or cancelled, prior to confirmation of the Revco Plan. Under section 108(e)(6) of the Tax Code, a Revco Debtor whose intercompany obligation is contributed to capital is treated as satisfying the debt with a payment of cash in an amount equal to the basis in the intercompany debt of the company making the capital contribution, if the intercompany claims are contributed to capital, the Revco Debtors intend to take the position that confirmation of the Revco Plan will not result

in discharge of indebtedness with respect to any such intercompany advance provided the contributor's tax basis in the obligation equals the amount of the obligation.

The Revco Debtors intend to take the position that the discharge of indebtedness of any one Revco Debtor does not affect the NOLs of the other Revco Debtors. No Treasury regulations have been promulgated on this issue. The Revco Debtors requested a ruling on this issue and were informed that the IRS is not prepared to rule favorably. The Revco Debtors subsequently withdrew the ruling request. If the IRS were to succeed in challenging the Revco Debtors' position on this issue, all NOLs would be eliminated.

B. IMPACT OF DISCHARGE OF INDEBTEDNESS ON NOLS.

The Revco Debtors estimate that, after application of the discharge of indebtedness rules, the NOLs available to the Reorganized Companies, subject to utilization pursuant to the section 382 limitation discussed above, should be at least $100 million. The Revco Debtors' estimate of available NOLs and the amount of the section 382 limitation is subject to audit and possible adjustment by the IRS. In addition, the amount of the Revco Debtors' NOLs may be affected by other aspects of the Plan, including the Merger and certain other intercompany transactions. The Revco Debtors do not believe that these aspects of the Plan will have a material adverse effect, in the aggregate, on the NOLs, although it is not possible to provide assurances in this regard. An elimination or a reduction in the estimated remaining NOLs could have a material adverse impact on the cash flow from operations projected by the Revco Debtors.

4. Corporate Alternative Minimum Tax.

For purposes of computing a corporation's regular tax liability imposed under section 11 of the Tax Code, all the income recognized in a taxable year may be offset by the NOLs permitted to be utilized in that year. For purposes of the 20 percent alternative minimum tax on alternative minimum taxable income imposed under section 55 of the Tax Code, however, only 90 percent of a corporation's alternative minimum taxable income may be offset by NOLs (as computed for alternative minimum tax purposes). Therefore, the Reorganized Companies will be required to pay alternative minimum tax, at a minimum effective rate of two percent (10% of the 20% alternative minimum tax rate), in any succeeding taxable year during which they have alternative minimum taxable income and their regular tax is fully offset by NOLs.

B. FEDERAL INCOME TAX CONSEQUENCES TO CREDITORS.

1. Creditors Whose Claims Constitute Securities.

Whether a claim constitutes a security for federal income tax purposes depends on the facts and circumstances surrounding the origin and nature of the claim. Prominent factors that have been relied on in determining whether an obligation constitutes a security include: (a) the term of the instrument, (b) whether the instrument is secured, (c) the degree of subordination of the instrument, (d) the ratio of debt to equity of the issuer, (e) the riskiness of the business of the issuer, and (f) the negotiability of the instrument. Although not free from doubt, the debt securities being issued pursuant to the Revco Plan (the "New Securities") should qualify as securities for federal income tax purposes. The remainder of this discussion assumes that the New Securities qualify as securities for federal income tax purposes. However, the Rights should not be treated either as common stock or as securities for federal income tax purposes. All creditors who receive New Common Stock or New Securities in exchange for their Claims should consult their tax advisors to determine whether their Claims constitute securities for federal income tax purposes.

Holders of securities that exchange their securities for New Common Stock or New Securities will not recognize gain or loss for federal income tax purposes to the extent that their securities are exchanged for New Common Stock and New Securities except (as discussed below) to the extent that such New Common Stock or any New Securities are attributable to interest accrued after the beginning of its holding period and the holder has not already included the interest in income for federal income tax purposes.

Notwithstanding the foregoing, holders of securities who receive cash and/or Rights as well as New Common Stock or New Securities and who realize gain on the exchange will recognize gain in an amount equal to the lesser of the amount of the gain or the amount of cash and the fair market value of any Rights received. Holders receiving Common Stock or New Securities are not permitted to recognize any loss.

Holders of securities who receive only cash and/or Rights in exchange for their securities will recognize gain or loss equal to the difference between the cash received plus the fair market value of any Rights received and the holder's tax basis in the securities exchanged therefore.

It is unclear how holders who receive cash pursuant to the Cash Election would be treated. They could be treated either (i) as having received New Common Stock in exchange for the portion of their Claim subject to the Cash Election and immediately having sold such stock for the cash received or (ii) as having received such cash directly in exchange for the portion of their Claim that was the subject to the Cash Election. The tax consequences to a holder should be essentially the same under either treatment.

The basis of New Common Stock or New Securities received by a security holder in exchange for his securities (other than in respect to interest) will be equal to the holder's basis in the surrendered securities, decreased by the amount of cash and the fair market value of Rights received for the securities, and increased by the amount of gain recognized on the exchange. The basis of Rights received in exchange for a security generally will be equal to the fair market value of the Rights. The holding period for the New Common Stock and New Securities (other than in respect of interest) will include the period during which the creditor held the securities exchanged therefor, provided the securities were held as a capital asset on the date of the exchange.

2. Creditors Whose Claims Do Not Constitute Securities.

A creditor whose Claim does not constitute a security for federal income tax purposes will realize and recognize gain or loss on the exchange of the Claim in an amount equal to the difference between the holder's basis in the Claim and the amount realized in exchange therefor. The amount realized for a Claim will be the amount of cash and the fair market value of any New Common Stock, Rights and rights to share in the Dworkin Unwind litigation proceeds received, other than amounts received allocable to interest. Because it is unclear whether the rights to share in the Dworkin Unwind litigation proceeds will have an ascertainable value when they are distributed pursuant to the Revco Plan, there is considerable uncertainty as to the proper time for recognition of any gain or loss by holders of General Unsecured Claims who receive such rights. In addition, because a loss will be allowed as a deduction only for the taxable year in which the loss was sustained, a creditor that claims a loss in the wrong taxable year risks denial of such loss altogether. Therefore, holders of General Unsecured Claims may wish to consult their tax advisors regarding the timing and amount of any recognized gain or loss.

The tax basis of property received in exchange for Claims that do not qualify as securities for federal income tax purposes will be the amount of the property that is included in the creditor's amount realized on the exchange. The aggregate basis will be apportioned among the properties received in proportion to their relative fair market values on the date of the exchange. The holding period for the properties will begin on the day following the exchange.

3. Receipt of Interest.

Each creditor will recognize ordinary income to the extent that it receives any cash or property that is allocable to accrued interest income that has not already been included for federal income tax purposes in its taxable income. A creditor that had previously included income accrued but unpaid interest attributable to its Claim will recognize a loss (generally deductible in full against ordinary income) to the extent such accrued and unpaid interest is not satisfied in full. The proper allocation between principal and interest of amounts received in exchange for the discharge of a Claim not paid in full is unclear. Creditors are advised to consult their own tax advisors to determine the amount of consideration received under the Revco Plan that is allocable to interest.

4. Original Issue Discount.

Some or all of the New Securities may be issued with original issue discount. A holder of a New Security having original issue discount will be required to include in gross income a portion of such original issue discount as determined on a constant yield basis. In general, original issue discount is defined as the excess of the "stated redemption price at maturity" of a debt instrument over its "issue price." Each class of New Securities issued pursuant to the Revco Plan should pay only "qualified periodic interest payments." Therefore, their stated redemption price at maturity should equal their principal amount. The issue price of a New Security will depend in part on whether the New Security or the securities exchanged therefore are traded in an "established securities market" and the price at which they are traded. It is therefore impossible to determine at this time whether the New Securities would be issued with original issue discount.

If a class of New Securities is issued with original issue discount, a holder should be able to reduce the annual amount of original issue discount income inclusions by the excess of the adjusted basis of the New Securities in that class received by such holder over the issue price of the New Securities under the rules of section 1272(a)(7) of the Tax Code regarding "acquisition premium." Under

such rules, the original issue discount includable in such a holder's income for a taxable period will be reduced by an amount equal to the original issue discount as otherwise determined to be includable for such taxable period multiplied by a fraction, the numerator of which is the excess basis over the issue price, and the denominator which is the original issue discount for the total period remaining to maturity.

The above discussion is based in part on proposed Treasury regulations (which may be modified before they are finalized). Each holder is advised to consult its own tax advisor regarding the amount of any original issue discount and the manner in which such original issue discount will be taxed.

5. Certain Federal Tax Consequences of Holding Rights.

Holders of the Rights who exercise such Rights will have a tax basis in the New Common Stock received for exercise of such Rights equal to their basis in such Rights plus the price paid upon exercise. A holder who disposes of its Rights in a taxable transaction without having exercised such Rights will recognize gain or loss in an amount equal to the difference between the holder's basis in its Rights and the price received. Such gain or loss should be capital gain or loss if the Rights were held as capital assets. Any loss from the expiration of the Rights should be a capital loss if the Rights were held as capital assets.

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Voting stock, § 5.4(a)(ii)(A)

Waiver of sovereign immunity, § 10.3(m)
tax determination, § 10.3(a)
Watts, § 7.2(b)(iv)
Wessel, §§ 5.7(c), 5.7(c)(ix)
Willfully standard, § 11.2(f)(i)(A)
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Worthless securities, *see* Security losses
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Yates, §§ 2.9(a), 9.3(g)
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